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No. 06-

IN THE

# Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
*Petitioners,*

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
*Respondents.*

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit**

## PETITION FOR A WRIT OF CERTIORARI

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## QUESTION PRESENTED

Whether, and to what extent, a court must consider or weigh competing inferences in determining whether a complaint asserting a claim of securities fraud has alleged facts sufficient to establish a "strong inference" that the defendant acted with scienter, as required under the Private Securities Litigation Reform Act of 1995.

## PARTIES TO THE PROCEEDING

Petitioners, defendants-appellees below, are Tellabs, Inc., and Richard C. Notebaert. Additional defendants-appellees below are Michael J. Birck, Joan E. Ryan, Brian J. Jackman, Robert W. Pullen and John C. Kohler, all of whom are former officers or directors of Tellabs, Inc. Petitioner Tellabs, Inc. has no parent company, and no publicly held company owns 10 percent or more of Tellabs' shares.

Respondents are Makor Issues & Rights, Ltd, a corporation appointed as lead plaintiff-appellant below, and the individuals Chris Broholm, Richard LeBrun, David Leehey and Patricia Morris, all of whom purport to act on behalf of themselves and a class of all persons similarly situated.

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## PETITION FOR A WRIT OF CERTIORARI

Petitioners Tellabs, Inc. and Richard C. Notebaert respectfully request that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

## OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit was entered on January 25, 2006. That opinion was modified (on an issue that is not the subject of this petition) by an order entered on July 10, 2006. That Order is included in the Appendix at 118a-119a. The modified opinion is included in the Appendix ("App.") at 1a-27a. It has been officially reported and can be found at *Makor Issues & Rights, Ltd.* v. *Tellabs, Inc.*, 437 F.3d 588 (7th Cir. 2006). The opinion and order of the United States District Court for the Northern District of Illinois dismissing

respondents' Second Consolidated Amended Class Action Complaint ("Second Amended Complaint") was entered on February 19, 2004, and is included in the Appendix at 28a-79a. That opinion has been reported and can be found at *Johnson* v. *Tellabs, Inc.*, 303 F. Supp. 2d 941 (N.D. Ill. 2004). The opinion and order of the United States District Court for the Northern District of Illinois dismissing respondents' Consolidated Amended Class Action Complaint was entered on May 19, 2003, and is included in the Appendix at 80a-117a. That opinion has also been reported and can be found at *Johnson* v. *Tellabs, Inc.*, 262 F. Supp. 2d 937 (N.D. Ill. 2003).

## JURISDICTION

The court of appeals issued its original opinion on January 25, 2006. Petitioner timely sought rehearing, which resulted in an order modifying the original opinion dated July 10, 2006. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

## STATUTORY PROVISION INVOLVED

Section 21D of the Securities Exchange Act of 1934, 15 U.S.C. § 78u-4, was added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747. Section 21D provides, in pertinent part, as follows:

> (2) REQUIRED STATE OF MIND.—In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

## STATEMENT OF THE CASE

This case presents a deep split of authority with respect to what is perhaps the most important provision of a frequently invoked federal statute. The Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737 ("Reform Act" or "PSLRA"), was passed by Congress to provide a strict, nationally uniform standard by which complaints alleging securities fraud under federal law would be judged. Congress deliberately chose to require that such complaints plead particularized facts creating a "strong inference" that the defendant acted with the culpable mental state required for liability. 15 U.S.C. § 78u-4(b)(2). Absent compliance with this requirement, litigation is not permitted to proceed past a motion to dismiss, thereby preventing the substantial litigation costs that too often forced defendants in such suits to settle even non-meritorious claims.

More than 10 years later, there is not the clear, uniform standard that Congress envisioned. Scienter is, of course, the culpable mental state required for a claim under Section 10(b) of the Securities Exchange Act of 1934, and is generally proved by inference rather than with direct evidence. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 391 n.30 (1983). The various courts of appeals have adopted four meaningfully different interpretations of the "strong inference" standard as applied to claims of scienter. There is now a 4-2-2-1 split of authority regarding whether and how a court applying the "strong inference" standard should consider the inferences of an innocent mental state that could be drawn from the complaint's allegations. Only this Court can resolve this important conflict.

The Seventh Circuit, in the case at hand, has determined that in ascertaining whether a "strong inference" of scienter has been adequately pleaded, it will not consider competing inferences of an innocent mental state that may also be drawn from the alleged facts. To consider the strength of innocent inferences as against any potentially culpable inferences at the

pleading stage, the Seventh Circuit reasoned, might "be misunderstood as a usurpation of the jury's role" in potential violation of the Seventh Amendment. Pet. App. 20a. To avoid this possibility, the Seventh Circuit held that a securities fraud complaint should survive "if it alleges facts from which, if true, a reasonable person *could* infer that the defendant acted with the required intent." *Id.* (emphasis added).

Six other circuits allow innocent inferences to play a significant role in evaluating whether a complaint alleges facts from which a "strong inference" that the defendant acted with scienter may be drawn. All of these circuits reject the "could infer" standard of the court below, even as those six circuits disagree on what role reasonable innocent inferences should play in the analysis.

Four circuits—the First, Fourth, Sixth and Ninth—require a direct comparison of the plausibility of competing inferences. These courts have held that a court should consider all the reasonable inferences that might be drawn (both of scienter and of an innocent mental state) and then compare the relative plausibility of the culpable inference to the innocent inference. Unless the culpable inference is the *most* plausible, then it is not "strong" and the complaint should be dismissed. See *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005); *Ottman* v. *Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003); *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001); *Gompper* v. *VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002).

The Tenth Circuit also considers all the inferences, both of scienter and of an innocent mental state, that may be drawn from the record. *Pirraglia* v. *Novell, Inc.*, 339 F.3d 1182, 1187-88 (10th Cir. 2003). But the Tenth Circuit has expressly declined to follow the view, which it associated with the Sixth Circuit, that only the "'most plausible of competing inferences'" is "strong." *Id.* at 1188. And the Tenth Circuit has ruled that courts should not directly weigh the relative

plausibility of competing innocent and culpable inferences. *Id.* (emphasizing that the Tenth Circuit's approach "does not involve a 'weighing' of the plaintiff's suggested inference against other inferences"). The Tenth Circuit nonetheless considers the innocent inferences to determine "whether plaintiff's suggested inference is 'strong' in light of its overall context." *Id.* The Eighth Circuit considers innocent and culpable inferences similarly. *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 666-67 (8th Cir. 2001).

Finally, two courts—the Second and Third Circuits—have adopted an altogether different approach to evaluating whether the "strong inference" of scienter exists. Rather than consider all the allegations together, these courts have divided the allegations relating to mental state into two distinct types, "motive and opportunity" on the one hand, and "strong circumstantial evidence" that a defendant knowingly or recklessly issued false statements on the other, either of which might independently satisfy the "strong inference" standard. *Kalnit* v. *Eichler*, 264 F.3d 131, 138 (2d Cir. 2001); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534-35 (3d Cir. 1999).

That diverse approaches to the interpretation and application of the "strong inference of scienter" standard currently prevail in the courts of appeals is directly contrary to Congress's intent to create a uniform standard for pleading securities fraud nationwide. See H.R. Rep. No. 104-369, at 41 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 740. In addition, the weakened version of the "strong inference" standard adopted by the Seventh Circuit in this case, the most lenient of any circuit, is also inconsistent with Congress's expressed desire to end the pernicious practice of pleading fraud with hindsight whenever a company's stock price tumbles, subjecting businesses to the Hobson's choice of paying out a quick settlement for a baseless claim or incurring massive risk and litigation costs. See S. Rep. No. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683. Only this

Court can clarify the "strong inference" standard—particularly how lower courts should consider inferences that the defendant was innocent—and provide the uniformity that Congress indisputably sought.

### A. Nature Of The Case.

Petitioner Tellabs, Inc. is a manufacturer of specialized optical networks and broadband access equipment whose primary customers are telecommunications carriers as well as internet service providers. Petitioner Richard Notebaert was the CEO of Tellabs during the period relevant to this case. Like many of its competitors, Tellabs experienced a decrease in demand for its products during 2001, when the telecommunications and technology sectors suffered a severe contraction. The price of Tellabs shares consequently declined.

As is relevant here, respondents, plaintiffs below, representing a proposed class of Tellabs shareholders, sued Tellabs and several of its officers and directors under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a). Respondents alleged that defendants had engaged in a scheme to inflate Tellabs' stock price between December 11, 2000 (the date when Tellabs first issued its projections for 2001 revenue) and June 19, 2001 (the date Tellabs withdrew its previous guidance for 2001 revenue and revised its projection of revenue for the second quarter of 2001).[1] In general, respondents alleged that Tellabs improperly booked revenue for the fourth quarter of

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[1] Between those dates Tellabs revised its guidance several times, including decreasing its projected revenue for the first quarter of 2001 by approximately $90 million on April 6, 2001, and, on April 18, 2001, decreasing expected annual revenue for 2001 to an amount that was approximately $800 million less than originally forecast.

2000 and that, during the relevant period, Tellabs' revenue projections for 2001 were false.

As the case arrives at this Court, the relevant factual allegations have been substantially narrowed. And the only allegations of scienter held sufficient to support a Section 10(b) claim are those pertaining to Notebaert.

1. Respondents' claim that Tellabs' fourth quarter 2000 financial statements were intentionally false is based on certain allegations of what they term "channel stuffing." The complaint alleges that Notebaert worked with Tellabs personnel to engage in "channel stuffing" and "unquestionably knew" that "channel stuffing" was occurring. Pet. App. 25a. However, the complaint defines "channel stuffing" to include not only improper conduct (such as writing orders for products customers had not requested), but also conduct that is *not* improper, such as "offering customers discounts of as much as 10% to 20%" and extending credit terms from 30 to 90 days. *Id.* at 58a.

Respondents used this broad definition of "channel stuffing" in the Second Amended Complaint despite having been admonished by the district court, in dismissing an earlier version of the complaint, that "there certainly is nothing inherently wrong with offering incentives to customers to purchase products." Pet. App. 99a-100a. And when the Second Amended Complaint alleges that Notebaert worked with Tellabs personnel to engage in "channel stuffing," and knew that "channel stuffing" was occurring, it does not specify the type of "channel stuffing" activity engaged in by Notebaert; nor does it specify whether it is referring to his alleged knowledge of mere discounts and sales incentives or to the improper shipping of unordered products, both of which respondents lumped together under the term "channel stuffing."

2. As alleged by respondents, the reduction in projected second quarter earnings that Tellabs announced on June 19, 2001—an event that Petitioners characterize as disclosure of

"the truth"—was due almost entirely to a decrease in demand for the TITAN 5500, Tellabs' most popular optical networking product. Pet. App. 4a-5a. The claim that Petitioners falsely inflated Tellabs' projections for 2001 is, in turn, based largely on certain earlier statements that Notebaert made concerning the TITAN 5500.

As recounted by the Seventh Circuit, at various points in February, March and April of 2001, Notebaert made public statements of confidence in demand for the TITAN 5500. Specifically, in the 2000 Annual Report, published on February 14, 2001, Notebaert stated that the TITAN 5500, though ten years old, "'is still going strong.'" Pet. App. 23a. In a conference call with investors on March 8, 2001, Notebaert was asked by an analyst whether Tellabs was experiencing weakness in demand for the TITAN 5500; Notebaert responded that Tellabs was not and that the product was continuing "'to maintain its growth rate.'" *Id.* at 3a. On April 6, 2001, Notebaert told analysts that customers were indicating that "'in-user demand for services continues to grow.'" *Id.* at 23a.

Respondents alleged that Notebaert's statements of confidence in customer demand for the TITAN 5500 were knowingly false because Tellabs had commissioned a report by Probe Research that analyzed the strength of demand for that product. The complaint did not specify when this report was received by Tellabs, other than vaguely to assert that it was delivered "'in or about early 2001.'" Pet. App. 23a. According to respondents, however, the Probe Report led to a conclusion that 2001 revenue from the TITAN 5500 would decline by $400 million. Respondents also alleged that a confidential source reported that Tellabs had produced "internal reports" that "revealed by March 2001 that the market for the 5500 was drying up. *Id.* The complaint does not allege that Notebaert received or read either the Probe Research report or any of the unspecified, adverse internal reports, or was otherwise made aware of such reports, prior to having made any of his allegedly false statements.

Critical context as to these allegations was provided by publicly available documents that were referred to in the complaint and properly before the courts below. These documents made clear that on April 6, 2001, Tellabs began a public process of lowering its revenue projections precisely because, as it explicitly informed the market, it had observed a diminution in orders *during the latter portion of March 2001*. On April 6, Tellabs reduced its first quarter revenue guidance to $772 million (down from a range of $830 to $865 million). Tellabs specifically stated, in its analysts conference call held that same day, that it had experienced a fall-off in orders for the TITAN 5500 during the last two and half weeks of the first quarter (the end of March—which is consistent with the complaint's allegation that Tellabs produced internal reports in March 2001 indicating that demand for the product was weakening). Moreover, less than two weeks later, on April 18, 2006, Tellabs reduced its full year revenue projections to $3.6 to $3.7 billion, a nearly $800 million reduction from its original projections for 2001. Pet. App. 37a. This reduction is roughly double the $400 million reduction in revenue projections alleged to have been suggested by the internal report upon which respondents rely to establish Notebaert's scienter.

The reduction was accompanied by a clear statement that the business environment in which Tellabs was operating had changed within recent weeks. Tellabs explicitly advised that its customers were deferring, and in some cases reducing, capital spending. Pet. App. 36a-37a. Still, despite the reductions and concerns about the recent change in the business environment, Tellabs reported that sales in the first quarter of 2001, while not meeting its expectations for 30% growth, did grow by 21% over the prior year's first quarter, *id.* at 4a, which is consistent with Notebaert's alleged statement on April 6, 2001 that demand for the TITAN 5500 was continuing to grow. *Id.* at 23a. Respondents have never challenged the accuracy of those reported results for the first quarter of 2001. *Id.* at 64a.

3. Finally, respondents alleged certain false statements with respect to the TITAN 6500, which was then one of Tellabs' new products. Notebaert publicly stated, in March and April 2001, that customer demand for the 6500 was strong and that the company was shipping the product. As for the claim that Notebaert knew his statements in the spring of 2001 regarding the TITAN 6500 were false, the complaint relies exclusively upon a single confidential source who admittedly was no longer with the company by December 11, 2000, the start of the class period. Pet. App. 72a. The complaint contained no allegation that the confidential source had specific information about what Notebaert knew about the TITAN 6500 during the class period, or any reason to believe the confidential source would have had such specific information. Respondents also alleged, based upon the same source, that a Tellabs statement in December 2000 that the TITAN 6500 was "available now," made in connection with announcement of a $100 million multi-year sales agreement with Sprint for the TITAN 6500, was false.[2] The statement in question was not Notebaert's, however, *id.* at 84a, and no facts as to Notebaert's involvement were alleged.

4. The complaint alleges that the supposed fraud ended when Tellabs announced, on June 19, 2001 (only part-way through the second quarter), that orders for the TITAN 5500 had declined. Based on this reduction in demand, Tellabs revised its revenue projections for the second quarter by $300 million, and withdrew its full-year guidance.

Though Notebaert was allegedly engaged in a fraud to misstate Tellabs' fourth quarter 2000 financial performance

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[2] The putative confidential source claimed that in addition to defendants Jackman and Pullen, both of whom were alleged to be active in the development of the TITAN 6500, "Notebaert also knew about the TITAN 6500 problems." No facts were alleged regarding this assertion as to what Notebaert "knew." And this was the totality of the 6500 allegations pertaining directly to Notebaert. On appeal, respondents abandoned their § 10(b) claims against Jackman and Pullen.

and its 2001 financial projections, the complaint does not provide any reason *why* Notebaert or Tellabs would have suddenly started knowingly to misstate Tellabs' performance in December 2000 and, just as suddenly, stopped making false statements in June 2001—while also making several public downward revisions in projections in between. Notebaert is not alleged to have sold *any* shares of Tellabs stock during the period of alleged stock price inflation, or to have received any other personal benefit. Nor did the Second Amended Complaint allege that this supposed close-ended fraud had been undertaken in order to produce any benefit for the Company.

**B. The District Court's Decisions.**

The district court twice dismissed respondents' claims in lengthy, reasoned orders. Pet. App. 28-117a. As relevant here, in its second order, dismissing the entirety of respondents' Second Amended Complaint, the district court carefully examined the allegations of channel stuffing and false statements with respect to the TITAN 5500 and the TITAN 6500. The district court concluded that the allegations that respondents claimed pointed toward scienter were too vague to support a "strong inference" of scienter.

Specifically, with respect to the channel stuffing allegations (which form the basis of the claim that Notebaert participated in knowingly falsely inflating Tellabs' financial results for the fourth quarter of 2000), the district court noted that respondents had failed to "provide details" of precisely what "channel stuffing" activities Notebaert had engaged in. Pet. App. 74a. The district court noted that the absence of detail in the allegations was critical because the complaint had defined "channel stuffing" broadly enough to include innocent conduct. *Id.* at 58a, 74a, 99a-100a. These allegations were not enough, in the district court's view, to create a "strong inference" that Notebaert knowingly or recklessly engaged in improper channel stuffing activities.

The district court also examined the claim that the allegations regarding the Probe Research report, along with Tellabs' own internal reports, supported an inference that Notebaert acted with scienter in his statements about continued demand for the TITAN 5500. The district court first noted the conspicuous imprecision with respect to the alleged dates of the reports. Pet. App. 65a. The district court also noted that the complaint nowhere indicated "when Tellabs' revenue would feel the effect" of the allegedly predicted drop in demand. *Id.* The imprecision of the allegations was sufficient, according to the district court, to render the inference of scienter too weak to survive a motion to dismiss.

Finally, with respect to the remaining alleged false statements by Notebaert, the district court concluded that general allegations regarding "Notebaert's position in the company and general conclusions regarding his knowledge of the allegedly fraudulent activities without providing particulars" could not support a "strong inference" of scienter. Pet. App. 74a. Respondents' conclusory allegations regarding Notebaert's putative knowledge of problems with the TITAN 6500 were just that: allegations based on the non-specific assertion of a confidential source who had departed the company prior to the class period.

**C. The Seventh Circuit's Decision.**

1. Respondents appealed the dismissal of their § 10(b) claims against the company, Notebaert, and Tellabs' chairman of its Board, Michael Birck; the dismissal of the § 10(b) claims asserted against the remaining 4 of 6 individual defendants named in the complaint was not appealed. The Seventh Circuit affirmed the dismissal of the § 10(b) claims as to Birck, but reversed the dismissal as to Notebaert and the company.[3]

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[3] Respondents had also asserted control person liability claims under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a), against the various

As relevant here, the Seventh Circuit began with a discussion of the "strong inference of scienter" pleading standard. Pet. App. 17a-19a. Initially, the court rejected the position adopted by the Second and Third Circuits, discussed above, *supra* at 5, that courts should distinguish between different types of allegations for purposes of the "strong inference" analysis. Pet. App. 20a. The Seventh Circuit continued by identifying another disagreement among the courts of appeals regarding the "strong inference" standard: what it termed "the degree of imagination courts can use in divining whether a complaint creates a 'strong inference.'" *Id.* The court was referring to the possibility that allegations in a complaint might give rise to competing inferences with respect to a defendant's mental state, and that courts must decide whether and how much to credit possible innocent inferences against possible culpable inferences.

As the court noted, the Sixth Circuit has expressly held that a strong inference under the PSLRA must be "'the most plausible of competing inferences.'" Pet. App. 20a (quoting *Fidel* v. *Farley*, 392 F.3d 220, 227 (6th Cir. 2004)). The Seventh Circuit expressly rejected that view.

In so ruling, the court suggested that consideration of competing inferences "could potentially" infringe on a plaintiff's Seventh Amendment rights to have a jury draw reasonable inferences in its favor. Pet. App. 20a. Having raised the possibility of a Seventh Amendment issue attached to any weighing of inferences, the court, "while express[ing] no view" on the merits of that putative issue, proceeded to adopt a standard expressly designed to avoid the issue. Specifically, to avoid the possibility of "usurp[ing] the jury's

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individual defendants, and appealed the dismissal of those claims too as to Notebaert, Birck and two of the other individual defendants. In addition, respondents had asserted and appealed a claim for insider trading against Birck under 15 U.S.C. § 78t-1(a). The Seventh Circuit has allowed these additional claims to survive. Those claims are all derivative of the § 10(b) claims against Notebaert and the company, however.

role," the Seventh Circuit adopted a standard that "allow[s a] complaint to survive if it alleges facts *from which a reasonable person could* infer that the defendant acted with the required intent." *Id.* (emphasis added).

2. Consistent with its view that the strong inference standard requires a court to credit what a reasonable person "could" infer, the Seventh Circuit read the ambiguous allegations with respect to whether and when Notebaert became aware of weakness in demand for the TITAN 5500 in respondents' favor, without any consideration for the plausible inferences of an innocent mental state that could be drawn from the same facts. For example, the court noted that the complaint "somewhat vague[ly]" stated that the Probe Research report was created "'in or about early 2001.'" Pet. App. 23a. The court also noted the allegation that internal reports, created at an unspecified time in "March 2001," revealed that demand for the TITAN 5500 was declining.

These allegations, which the court relied upon heavily, were conspicuously ambiguous. First, the timing of the Probe Research report and alleged internal reports was left uncertain. The question of timing was critical, however, to Notebaert's alleged knowledge of the falsity of statements he made about the TITAN 5500, *e.g.*, in February and *early* March. And, this question of timing was particularly acute given that on April 6, 2001, Tellabs itself had publicly disclosed a drop-off in orders for the TITAN 5500 in the last weeks of March, and publicly reduced its first quarter guidance as a result—followed twelve days later by another reduction in its full-year estimates, producing a 2001 total projection that was $800 million less than originally forecast. Second, the court itself observed that it was "conceivable" that Notebaert had not seen the alleged reports at the time of his statements. In fact, the Second Amended Complaint (like prior versions) contained no allegation that he had. The court noted, however, the existence of an allegation that Notebaert had generally "stayed on top of the company's financial health." Pet. App. 23a.

The court nonetheless proceeded to reward respondents' ambiguous pleading as to Notebaert by crediting the inferences of scienter because they were within the realm of what a reasonable person might infer. Pet. App. 23a ("the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false"). In doing so, the court made no mention and took no account of competing innocent inferences arising from, for example, the Company's voluntary, downwardly revised estimates made on April 6 and 18, and its accompanying disclosures of a weakening market.

Similarly, the court found that the complaint adequately alleged scienter with respect to the fourth quarter 2000 results because the complaint alleged that Notebaert knew about the "channel stuffing." Continuing to credit only a culpable inference if the alleged facts "could" support an inference of scienter, the court treated the "channel stuffing" allegation as if it alleged that "channel stuffing" meant *only* that "employees fabricated purchase orders for products that customers had not ordered." The court did not acknowledge what the District Court recognized, which is that the complaint defined "channel stuffing" to include innocent conduct, and failed to specify which type of conduct Notebaert had allegedly engaged in. Pet. App. 25a.

Finally, consistent with its refusal to consider potentially offsetting inferences, the Seventh Circuit did not consider or attempt to weigh the fact that the record revealed no apparent motive for Notebaert to engage in fraud during the class period, or any benefit either to him or the company. The Seventh Circuit simply closed its eyes to the innocent inferences that were readily available because its interpretation of the "strong inference" standard required that it not use its "imagination" to consider those innocent explanations at all.

## REASONS FOR GRANTING THE PETITION

Congress passed the Reform Act in 1995 in response to a clear and abiding desire to bring an end to abusive strike suits involving meritless claims of securities fraud. S. Rep. No. 104-98, at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683. Such claims were often "based on nothing more than a company's announcement of bad news, not evidence of fraud." *Id.* Defendants often quickly settled regardless of merit in order to avoid the expense and risk of litigation. *Id.* at 9, *reprinted in* 1995 U.S.C.C.A.N. at 688; see *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 347-48 (2005). The expense of such litigation was indirectly borne by the capital markets, imposing an additional cost on capital formation that hurt both investors and corporations. S. Rep. No. 104-98 at 4, *reprinted in* 1995 U.S.C.C.A.N. at 683.

Congress recognized that one source of the problem was that conflict among circuits on the legal standards for pleading securities fraud had created "opportunities for abuses." *Id.* In order to curb such abuses, Congress incorporated "uniform and more stringent pleading requirements" as a key feature of the Reform Act. H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740. One of the heightened pleading requirements is the critically important provision at issue here: a plaintiff must plead particularized facts giving rise to a "strong inference" that each defendant acted with the requisite mental state with regard to each alleged misrepresentation. 15 U.S.C. § 78u-4(b)(2). This constituted a marked departure from Fed. R. Civ. P. Rule 9(b), which otherwise allows state of mind allegations to be "averred generally." A complaint that fails to satisfy this heightened pleading burden cannot survive a motion to dismiss. 15 U.S.C. § 78u-4(b)(3)(a).

This case presents this Court with the opportunity to ensure that both of Congress's goals with respect to pleading of securities fraud complaints are satisfied. First, the legislative effort to provide uniformity has failed. The courts of appeals

have adopted meaningfully different interpretations of the "strong inference" standard, and of the role of competing inferences in judging whether any inference is "strong." Only this Court can establish a uniform standard. Second, the approach adopted by the Seventh Circuit in this case does serious violence to the deliberately high pleading standard adopted by Congress, and to its desire to provide businesses with relief from costly strike suits.

Both the different approaches among the federal courts of appeals and the Seventh Circuit's particularly lax standard for policing the scienter allegations in securities fraud complaints mark this case as an excellent vehicle for the Court to announce a uniform rule that meaningfully weeds out undeserving cases when the scienter allegations are insufficient. The federal securities fraud laws are frequently invoked in private litigation. According to the most recent statistics, there were 176 federal securities fraud class action claims filed in 2005 alone. Cornerstone Research, *Securities Class Action Case Filings: 2005: A Year in Review* 2 (2006), *available at* http://securities.stanford.edu/clearinghouse_research/2005_YIR/2006012302.pdf. Further, whether a complaint adequately alleges a "strong inference" of scienter is one of the most frequently litigated questions in such cases. Jonathan C. Dickey, *Current Trends in Federal Securities Litigation*, SL020 ALI-ABA 891, 906 (2005). The venue provisions of the securities laws provide for national service of process, 15 U.S.C. §§ 77v & 78aa, which gives the plaintiff in a securities fraud case flexibility with respect to the jurisdiction in which a claim can be filed. The potential for forum shopping in this commonly litigated area of the law exacerbates the inherent injustice of inconsistent application of federal law.

*1. There is a 4-2-2-1 split of authority over the interpretation of the "strong inference" standard and the role of competing inferences.* The courts of appeals have now presented four distinct approaches regarding whether, and to

what extent, courts should take into account inferences of a defendant's mental state that are innocent when determining whether the claimed inference of scienter is "strong." The different approaches reflect four very different ways of resolving a tension created by the "strong inference" standard.

In the ordinary case, a court ruling on a motion to dismiss draws all reasonable inferences in favor of the plaintiff. See *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). As various courts have observed, however, to credit only the inferences of a defendant's mental state that are in the plaintiff's favor—only the potentially culpable inferences—"would be to eviscerate the [Reform Act's] strong inference requirement by allowing plaintiffs to plead in a vacuum." *Gompper*, 298 F.3d at 896. If only the inferences in favor of plaintiffs are considered, according to these courts, then the "strong inference" requirement would amount to nothing more than a requirement that plaintiffs plead some facts that merely could reasonably point toward a culpable mental state, which would be contrary to the recognized view that Congress meant to raise the pleading bar for scienter. *E.g.*, *Helwig* 251 F.3d at 553 (strong inference requirement "represents a significant strengthening of the pre-PSLRA standard under Rule 12(b)(6), which gave the plaintiff the 'benefit of *all* reasonable inferences' and contemplated dismissal 'only if it is clear that no relief could be granted under *any* set of facts that could be proved consistent with the allegations'") (citations omitted).

Several courts have thus observed that "[i]n requiring a 'strong inference' of scienter, the PSLRA alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002) (the Reform Act "alters the usual contours of a Rule 12(b)(6) ruling"); *Green Tree*, 270 F.3d at 660-61 (noting that "Congress has effectively mandated a special standard for

measuring whether allegations of scienter survive a motion to dismiss") (citing *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999)). Rather than merely crediting inferences favorable to the plaintiff's view, some courts acknowledge that they also should consider the inferences of an innocent mental state favorable to the defendant. *Credit Suisse*, 431 F.3d at 51 (in a securities fraud case, a court should not "turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"); *Gompper*, 298 F.3d at 897 ("when determining whether plaintiffs have shown a strong inference of scienter, the court must consider *all* reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs"); *Pirraglia*, 339 F.3d at 1187 ("In evaluating the strength of a plaintiff's inference of scienter, we may recognize the possibility of negative inferences that may be drawn against the plaintiff.").

Still, among the courts that consider inferences favorable to the defendant, a dispute has emerged regarding how to incorporate those inferences into the analysis of whether the complaint adequately pleads facts establishing a "strong inference" of scienter. The First, Fourth, Sixth and Ninth Circuits have concluded that if the proposed inference of scienter is not the *most* plausible that may be drawn from the record, the inference of scienter is not "strong" within the meaning of the Reform Act. According to these courts, if an innocent inference is as plausible as a culpable inference, then the complaint should be dismissed. *Helwig*, 251 F.3d at 553 ("plaintiffs are entitled only to the most plausible of competing inferences"); *Gompper*, 298 F.3d at 896-97 (rejecting proposed inference of scienter where "it is equally if not more plausible" that defendants acted without fraudulent intent); *Credit Suisse*, 431 F.3d at 49 ("Scienter allegations do not pass the 'strong inference' test when, viewed in the light of the complaint as a whole, there are legitimate explanations for the behavior that are equally

convincing."); *Ottman*, 353 F.3d at 350 (rejecting inference of scienter because it "was just as likely" that the fact pattern alleged by plaintiffs was the result of an innocent "overgeneralization as it was the product of intentional deception or recklessness"). Under this standard, it is clear that the complaint in this case would be dismissed.

The Tenth and Eighth Circuits, however, do not require that an inference of scienter be more plausible than the inference of an innocent mental state in order to be characterized as sufficiently "strong." That decisional conflict by itself warrants this Court's review. The most thoroughly reasoned explanation for rejecting the "most plausible inference" approach has been provided by the Tenth Circuit in *Pirraglia*. There, the Tenth Circuit reasoned that weighing, in comparative fashion, the relative strength of competing inferences is not the province of a court ruling on a motion to dismiss. 339 F.3d at 1188. The Tenth Circuit expressly stated that if two inferences are "equally strong ..., one favoring the plaintiff and the other favoring the defendant," then the complaint should survive a motion to dismiss. *Id.* at 1187-88 (expressly rejecting the Sixth Circuit's standard in *Helwig*).

Rather than determine whether allegations give rise to a "strong inference" by evaluating which among competing inferences is the most plausible, the Tenth Circuit evaluates the strength of any scienter inference in light of "the context of other reasonable inferences that may be drawn." *Id.* at 1188. Ultimately, after considering all the facts and all the reasonable inferences drawn therefrom, the strength of any inference of scienter that emerges is subjected to a threshold standard. So long as that threshold of "strength" is met, the scienter pleading requirement is satisfied; it does not matter if the inference of scienter is the most plausible of the competing inferences. A "strong inference of scienter" in the Tenth Circuit is "a conclusion logically based upon particular facts that *would convince* a reasonable person that the

defendant knew a statement was false or misleading." *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003) (emphasis added). Moreover, in an attempt to reconcile the Reform Act with the traditional Rule 12(b)(6) standard that a complaint's factual allegations are to be viewed in the light most favorable to plaintiff, *Leatherman*, 507 U.S. at 164, the Tenth Circuit "will draw no inferences unfavorable to plaintiffs," but "will likewise refuse to draw inferences in the plaintiffs' favor" unless adequately supported in light of the "overall context." *Pirraglia*, 339 F.3d at 1187.

Like the Tenth Circuit, the Eighth Circuit has not adopted the "most plausible of competing inferences" standard of the Sixth Circuit. *In re K-tel Int'l, Inc. Sec. Litig.*, 300 F.3d 881, 889 n.6 (8th Cir. 2002). Instead, in *Green Tree* the Eighth Circuit, while not mentioning the Tenth Circuit by name, evaluated the complaint in a way that shows kinship with the Tenth Circuit's approach. The Eighth Circuit reversed the dismissal of a claim that company executives knowingly employed improper accounting practices to overstate the company's performance. The court recognized that the plaintiffs had alleged that the defendants possessed "knowledge of facts indicating crucial information in the statements was based on discredited assumptions." 270 F.3d at 665. It did not, however, stop there and hold that because a reasonable person might conclude that the defendants acted with scienter, the case must proceed. Rather, it confronted the defendants' alternative inferences pointing toward an innocent mental state. The defendants had argued that the accounting issues were complex for the sophisticated transactions at issue and that even "very large mistakes could fall within the realm of good faith." *Id.* at 666. The court recognized that "the defendants have many good arguments explaining how and why they thought their statements [were] proper." *Id.* at 667. Those arguments were not, however, strong enough to "sap[] the investors' allegations of their force at this procedural stage." *Id.*

The Seventh Circuit decision in this case provides a third approach. The Seventh Circuit, like the Tenth, expressly rejected the approach of four circuits that an inference of scienter is "strong" only if it is more plausible than any alternative inference. Pet. App. 20a. And, like the Tenth Circuit, the Seventh Circuit rejected such a comparative approach based on concerns about invading the province of the factfinder. *Id.* at 20a-21a (expressing concern that Sixth Circuit approach would violate the Seventh Amendment). But the Seventh Circuit went farther than any other court. Consistent with the Seventh Amendment concerns it voiced, the court created an especially liberal standard. A complaint should survive "if it alleges facts from which a reasonable person *could* infer that the defendant acted with the required intent." *Id.* at 20a (emphasis added). Conversely, only "[i]f a reasonable person could not draw such an inference from the alleged facts," is a defendant entitled to dismissal. *Id.* at 21a.

The Seventh Circuit's approach reflects the very approach specifically rejected by the Ninth Circuit in *Gompper*, 298 F.3d at 896. All that is necessary for a complaint to survive are facts from which it is merely reasonable to infer that the defendant acted with scienter. The Seventh Circuit nowhere qualified that analysis by recognizing or even discussing the importance of considering any inferences that the defendant acted with an innocent mental state. If a reasonable person "could" conceivably draw an inference of scienter, then the culpable inference is the only one a court should consider. The possibility that those same facts would support an innocent inference, or that other facts undermine the culpable inference, is legally irrelevant.

The limited nature of the Seventh Circuit's inquiry is confirmed by how it discussed the record in this case. Allegations that were said to support an inference of scienter were ambiguous enough, especially in the overall context of the record before the court, to support an inference of innocence. And, there were potential innocent inferences

arising from other facts before the court—*e.g.*, the April 6 and 18 downward guidance revisions and accompanying explanations—to which no consideration was afforded. The various other circuits discussed above would have wrestled with the innocent inferences, either to determine whether the inference of scienter was more plausible than the innocent inference (First, Fourth, Sixth and Ninth Circuits) or to determine whether the innocent possibility sufficiently weakened the inference of scienter to support dismissal (Eighth and Tenth Circuits). Further, the Tenth Circuit's threshold standard for an adequately "strong inference" is noticeably more exacting than that of the Seventh Circuit. The Tenth Circuit requires plaintiffs to plead "facts that *would convince* a reasonable person that the defendant knew a statement was false or misleading." *Adams*, 340 F.3d at 1105 (emphasis added). The Seventh Circuit has allowed a plaintiff to plead facts from which a reasonable person conceivably "*could*" draw an inference of scienter. Pet. App. 20a (emphasis added).

The Seventh Circuit's approach is substantially more lax than that taken by the Second and Third Circuits as well. As noted above, these courts divide scienter allegations into two types: motive and opportunity on the one hand, and strong circumstantial evidence of knowledge or recklessness on the other.[4] *Kalnit*, 264 F.3d at 138; *In re Advanta Corp.*, 180 F.3d at 534-35. How these courts apply the "strong

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[4] All the other courts of appeals to have considered the issue have held that the Reform Act requires courts to examine all the allegations in the complaint together, without drawing such distinctions. *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 196 (1st Cir. 1999); *Ottman*, 353 F.3d at 345; *Natheson* v. *Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir. 2001); *Hoffman* v. *Comshare (In re Comshare Sec. Litig.)*, 183 F.3d 542, 551 (6th Cir. 1999); Pet. App. 20a; *Green Tree*, 270 F.3d at 654-56; *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999); *City of Philadelphia* v. *Fleming Cos.*, 264 F.3d 1245, 1261-63 (10th Cir. 2001); *Bryant* v. *Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999).

circumstantial evidence" standard is particularly relevant. Where there are no allegations of motive, these courts require that the strength of the circumstantial evidence of knowledge of falsity must be greater. *Kalnit*, 264 F.3d at 142; *GSC Partners CDO Fund* v. *Washington*, 368 F.3d 228, 238 (3d Cir. 2004). Here, by contrast, the Seventh Circuit made no attempt to factor in the negative inference arising from the absence of any claimed motive for Notebaert to commit fraud.

Moreover, while the Second and Third Circuits have yet to rule on what role innocent inferences should play in evaluating a securities fraud complaint for "strong circumstantial evidence" of knowledge of falsity, both have acknowledged the potential importance of the issue. *Press* v. *Quick & Reilly, Inc.*, 218 F.3d 121, 130 (2d Cir. 2000) (stating that whether fact pointing toward an innocent mental state could "negate allegations of fraudulent intent ... raises serious concerns"); *Rombach* v. *Chang*, 355 F.3d 164, 176 (2d Cir. 2004) (observing, *in dicta*, that a fact from which an innocent mental state may be inferred can "weaken[]" the strength of an inference of scienter); *Digital Island*, 357 F.3d at 328 (noting that "strong inference" standard "alters the normal operation of inferences" for a Rule 12(b)(6) motion). Both courts have largely avoided the issue for now because they categorically do not allow precisely the sort of ambiguous allegations presented here to suffice. These courts require that a plaintiff plead that a defendant had "knowledge of facts or access to information contradicting their public statements" at the time the public statements were made. *Novak* v. *Kasaks*, 216 F.3d 300, 308-09 (2d Cir. 2000); *GSC Partners*, 368 F.3d at 239-45. These courts apply this standard strictly by insisting upon particularized allegations that make clear that the relevant information was provided to the defendant. *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, 250 F.3d 87, 100 (2d Cir. 2001) (claim allowed to proceed against one insider defendant who had allegedly seen original report that had expressed concerns that

were omitted from later distributed modified report, but claim dismissed as to other insider defendants because no allegation that they had seen original report); *In re Alpharma Inc. Sec. Litig.*, 372 F.3d 137, 150-51 (3d Cir. 2004) (no strong inference of scienter as to insider defendants when there was no allegation that a whistleblower report of financial improprieties at the company's Brazilian subsidiary had been passed on to the defendants); *In re Suprema Specialties, Inc. Sec. Litig.*, 438 F.3d 256, 278-79 (3d Cir. 2006) (strong inference of scienter alleged as to two insider defendants who allegedly excluded other employees from certain accounts with customers when those customers had pled guilty to creating false invoices and falsely labeling products at the direction of the company's management). The ambiguity in the timing of both the Probe Research report and the alleged internal reports, coupled with the admitted absence of any allegation that Notebaert saw any of these reports at the relevant time, would simply be fatal to the complaint in both the Second and Third Circuits.[5]

In the end, the contrast among the four different approaches is stark. The first two recognize the importance of considering plausible innocent inferences, but disagree regarding how to incorporate those inferences into determining whether any inference of scienter is "strong." The third, adopted by the Seventh Circuit in this case, eschews consideration of the innocent inferences and purports to protect the role of the factfinder by entertaining only the

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[5] The Second and Third Circuits also refuse to credit, as a substitute for particularized allegations of knowledge, the kind of generalized allegations accepted by the Seventh Circuit here, *i.e.*, that an executive "stayed on top of the Company's financial health," Pet. App. 23a. *Rombach*, 355 F.3d at 176 (allegation that defendants had "access to financial information and computer systems" is inadequate); *Advanta*, 180 F.3d at 539 (inadequate to allege that defendant "'must have known' a statement was false or misleading" because of his position in the company).

inferences favorable to the plaintiff. And to determine if those inferences should be credited, the Seventh Circuit asks only if a reasonable person "could" draw such inferences. The fourth approach has, for now, avoided determining how to incorporate innocent inferences by establishing a strict pleading standard, at odds with the Seventh Circuit's lax approach here, for claims that a defendant was aware of information contradicting his public statements at the time those public statements were made. This Court should grant the petition, reject the Seventh Circuit's approach, and provide an effective, clear, and uniform method for evaluating whether the inferences of scienter that may be drawn from a complaint are "strong" within the meaning of the Reform Act.

*2. This case presents an excellent vehicle to review the "strong inference" standard.* This case provides a strong record for this Court to consider and conclude whether and how to incorporate any inferences of an innocent mental state in the process of determining whether a securities fraud complaint alleges facts that create a "strong inference" that the defendant acted with scienter. The factual allegations at issue here are, at a minimum, subject to competing inferences (both innocent and culpable) in ways that arise frequently in securities litigation. For example, the complaint alleges the existence of internal reports discussing the declining demand for the TITAN 5500, but nowhere alleges that Notebaert actually reviewed any such report. Whether an executive of a corporation, by virtue of his position, "must have known" of internal reports commonly arises. See, *e.g.*, *Abrams* v. *Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir. 2002); *Fleming*, 264 F.3d at 1263-64; *Advanta*, 180 F.3d at 539; *In re AOL-Time Warner Sec. & ERISA Litig.*, 381 F. Supp. 2d 192, 224, 230 (S.D.N.Y. 2004); *Smith* v. *Circuit City Stores, Inc.*, 286 F. Supp. 2d 707, 715 (E.D. Va. 2003); *D. E. & J Ltd. P'ship* v. *Conaway*, 284 F. Supp. 2d 719, 743 (E.D. Mich. 2003), *aff'd*, 133 F. App'x 994 (6th Cir. 2005); *In re Acterna Corp. Sec. Litig.*, 378 F. Supp. 2d 561, 573-75 (D. Md. 2005); *In re Cree, Inc. Sec. Litig.*, 333 F. Supp. 2d 461, 475 (M.D.N.C.

2004); *Lirette* v. *Shiva Corp.*, 27 F. Supp. 2d 268, 283 (D. Mass. 1998) (citing *Maldonado* v. *Dominquez*, 137 F.3d 1, 9 (1st Cir. 1998)).

Also, the particularly lax approach to pleading scienter adopted by the Seventh Circuit here provides an especially urgent reason for this Court's review. Not only do meaningful differences in the interpretation of the statute prevail, but the Seventh Circuit has adopted a standard that encourages plaintiffs to employ strategic ambiguity in their pleadings to survive a motion to dismiss and accomplish precisely what the Reform Act was supposed to end: the imposition of massive litigation costs on businesses based on little more than a downturn in share price.

Respondents' claim depends on such strategic ambiguity. For example, it is utterly unclear when Notebaert is alleged to have learned from the Probe Research report and internal reports—reports he is not even alleged to have seen—that demand for the TITAN 5500 was softening. The dates on which the reports were created and when Notebaert might have reviewed them are critical to establishing his scienter. Yet the complaint alleges only that the Probe Research Report was created "'in or about early 2001'" and that the internal report was created in March 2001. Pet. App. 23a. These alleged dates cover the period all the way through the end of March 2001, which is significant in light of the fact that on April 6, 2001, Tellabs began lowering revenue projections precisely because, as it expressly disclosed to the market on that day, there was an unanticipated fall-off in orders for the TITAN 5500 during the last two and a half weeks of March. And on April 18, 2001, Tellabs lowered its own revenue projection for all of 2001 to an amount that was $800 million less than originally forecast, an amount *greater* than that allegedly suggested by the Probe Research report. *Id.* at 23a, 37a. Put simply, these facts make it clear that an inference of an innocent mental state is perfectly consistent with the allegedly broad of range of time in which the reports were issued. The Seventh Circuit has rewarded this ambiguity by

giving respondents the advantage of the most favorable inference that might be drawn from it.

The same is true with respect to the allegations of "channel stuffing." The First Amended Complaint defined both legitimate and illegitimate conduct as "channel stuffing." Despite the opportunity to replead, after the district court identified this critical ambiguity in its first dismissal order, respondents neither narrowed their definition of "channel stuffing" nor ever specified which "channel stuffing" activities Notebaert allegedly knew about or participated in. They left the allegations as to his knowledge of "channel stuffing" ambiguous enough to mean knowledge of either legitimate or illegitimate conduct. Once again, the Seventh Circuit rewarded the ambiguity by crediting the inference most favorable to respondents. Pet. App. 25a.[6]

Any approach to the Reform Act that rewards strategic ambiguity in pleading should be rejected. The fact that the statute requires the pleading of particularized facts that give rise to "a 'strong,' rather than merely a 'reasonable,' inference that the defendant acted with scienter is more than an odd linguistic quirk." *Credit Suisse*, 431 F.3d at 48. Congress's intent in including the "strong inference" requirement was to raise the standard for pleading scienter in

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[6] The Seventh Circuit's lax application of the "strong inference" standard is further illustrated by how it concluded that the § 10(b) claim against the other individual defendant on appeal, Birck, should be dismissed. Birck had sold a small amount of stock during the class period, but the court concluded the sale was insufficient to establish any motive. In addition, Birck's last statement regarding the TITAN 5500 was in February 2001. But, as the court noted, the complaint's allegations supported an inference that the earliest date that "the TITAN 5500's declining status was obvious" to Tellabs executives was sometime in March 2001, Pet. App. 24a. Even though there was no motive, and even though there was no pleaded basis to infer that Birck had been aware of contrary information at the time of his last public statement, the court nonetheless deemed the question whether there was a "strong inference" of his scienter to be a "close" one. *Id.*

securities fraud actions to limit the types of cases that would be allowed to survive a motion to dismiss and go forward to discovery. *E.g.*, *Comshare*, 183 F.3d at 548 ("In 1995, Congress concluded that Rule 9(b) had not prevented abuse of the securities laws by private litigants.'") (quoting H.R. Rep. No. 104-369, at 41, *reprinted in* 1995 U.S.C.C.A.N. at 740)). The Seventh Circuit's decision to credit only the reasonable inferences that favor respondents' view effectively revives the traditional standard of pleading under Rule 8(a), under which a plaintiff is entitled to have all reasonable inferences drawn in its favor. See, *e.g.*, *Swierkiewicz* v. *Sorema N.A.*, 534 U.S. 506, 514 (2002). The Reform Act was supposed to put an end to precisely what the Seventh Circuit has allowed.

It was the Seventh Circuit's concern for avoiding supposed Seventh Amendment issues that led it to eschew competing negative inferences, and to focus only on whether reasonable inferences favorable to the plaintiff existed. Pet. App. 20a. That concern was misplaced. Congress's power to impose heightened pleading requirements, whether in a statute or in the Federal Rules of Civil Procedure, has never been questioned. *E.g.*, *Swierkiewicz*, 534 U.S. at 512-13; *Leatherman*, 507 U.S. at 168. Whether a complaint meets these requirements is a procedural matter, and a question of law, properly left to the courts. The jury trial right is simply not implicated at the motion to dismiss stage because "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Scheuer* v. *Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds*, *Harlow* v. *Fitzgerald*, 457 U.S. 800 (1982); see also *Baltimore & Carolina Line, Inc.* v. *Redman*, 295 U.S. 654, 657 (1935) (noting that the Seventh Amendment is not implicated where matters of procedure and issues of law are concerned). The "strong inference" standard reflects Congress's policy judgment that plaintiffs should be entitled to impose burdens on the defendants and the courts only if the plaintiffs already have acquired enough facts to

create a strong inference of scienter. And other courts that have similarly considered the Seventh Amendment have not understood the Constitution to bar them from giving due consideration to the inferences that may be drawn in favor of the defendant. *City of Monroe Employees Ret. Sys.* v. *Bridgestone Corp.*, 399 F.3d 651, 683 n.25 (6th Cir. 2005), *cert. denied sub nom.* 126 S. Ct. 423 (2005); *Pirraglia*, 339 F.3d at 1188.

In the end, the courts are deeply divided regarding how to give effect to the "strong inference" protections for securities fraud defendants that Congress adopted in the Reform Act. The Seventh Circuit has uniquely weakened those protections without warrant. This Court should accept review to ensure both the uniform and effective application of "strong inference" standard.

## CONCLUSION

This petition for writ of certiorari should be granted.

Respectfully submitted,

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# APPENDIX

# APPENDIX A

UNITED STATES COURT OF APPEALS
SEVENTH CIRCUIT

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No. 04-1687

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MAKOR ISSUES & RIGHTS, LTD., *et al.*,
*Plaintiffs-Appellants*,

v.

TELLABS, INC., *et al.*,
*Defendants-Appellees*.

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Argued Jan. 21, 2005
Decided Jan. 25, 2006
Rehearing en Banc Denied July 10, 2006
As Modified on Denial of Rehearing July 10, 2006

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Before RIPPLE, WOOD, and SYKES, *Circuit Judges*.

WOOD, *Circuit Judge*.

This class action against Tellabs, Inc., a manufacturer of specialized equipment used in fiber optic cable networks, presents the first opportunity for this court to address the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 (PSLRA), 15 U.S.C. § 78u-4(b). The plaintiffs have accused Tellabs and its executives of engaging in a scheme to deceive the investing public about the true value of Tellabs's stock. The district court dismissed the plaintiffs' second amended complaint, pursuant to Federal Rule of Civil Procedure 12(b)(6), after finding that the plaintiffs had failed to meet the PSLRA's pleading threshold. We affirm in part and reverse in part.

I

With the aid of 27 confidential sources, the plaintiffs, a putative class of Tellabs stockholders, allege that Tellabs's fraudulent conduct began on December 11, 2000. (We assume the truth of the well-pleaded allegations in the complaint, as we must upon review of a Rule 12(b)(6) dismissal.) See, *e.g., Harrell v. Cook,* 169 F.3d 428, 431 (7th Cir.1999). On that day, Tellabs issued a press release stating that Tellabs and Sprint had signed a multi-year, $100 million contract for one of Tellabs's next-generation products, the TITAN 6500. The release proclaimed that "[t]he TITAN 6500 system is available now." In a call to financial analysts later that day, Tellabs's Chief Executive Officer (CEO), Richard Notebaert, predicted that in addition to the contract with Sprint for the 6500, there would be "continuing growth of the TITAN 5500," referring to the 6500's predecessor. Based in part on these representations, most market analysts recommended that investors buy Tellabs's stock.

On January 23, 2001, in a press release announcing Tellabs's "record sales and earnings in the fourth quarter of 2000," Notebaert proclaimed that "customers are buying more and more Tellabs equipment." In an accompanying call to analysts, Notebaert stated that Tellabs had "set the stage for sustained growth with the successful launches of several products." Later, in response to a question, Notebaert stated, "On the 6500, demand for that product is exceeding our expectations." In another interview that day, Notebaert said, "we feel very, very good about the robust growth we're experiencing."

Continuing with these sunny assessments, on February 14, 2001, Tellabs sent a letter to stockholders, signed by Notebaert and Richard Birck, Tellabs's chairman and former CEO, that stated: "Tellabs'[s] growth is robust. . . . Our markets hold significant potential for sustained growth. . . . Our core business is performing well. . . . [S]ales of our

TITAN 5500 digital cross-connect systems soared 56% in 2000. . . . The new TITAN 6500 multiservice transport switch emerged from our laboratories in 2000, and customers are embracing it." In the annual report that accompanied this letter, Birck and Notebaert responded as follows to investors' frequently asked questions:

> Q. Your core business is built on the TITAN 5500—are you worried that this product has peaked?
>
> A. No. In 2000, TITAN 5500 revenues grew 56%, its best year so far. Although we introduced this product nearly 10 years ago, it's still going strong. . . .

The first public glimmer that business was not quite so healthy came in March 2001. At that time, Tellabs modestly reduced its first quarter sales projections from a range of $865 million to $890 million to a range of $830 million to $865 million. This revision was attributable to lower-than-expected growth in Tellabs's CABLESPAN® business, a product unrelated to this action. As Tellabs announced this reduction, it reiterated its positive forecasts for its other products. In a conference call with analysts, Notebaert stated:

> [D]emand for our core optical products, or our core networking products remains strong. . . . Interest in and demand for the 6500 continues to grow. . . . We continue to ship the 6100 and 6500 through the first quarter. We are satisfying very strong demand and growing customer demand. We are as confident as ever—that may be an understatement—about the 6500. . . . Tellabs will meet the adjusted revenue and earnings targets.

Notebaert maintained this upbeat tone while discussing the TITAN 5500. In response to an investor's question whether Tellabs was experiencing "any weakness [ ] at all" in demand for the 5500, Notebaert responded, "No, we're not. We're still seeing that product continue to maintain its growth rate." Tellabs's 10-K statement for the fiscal year ended December

29, 2000, filed three months later on March 29, 2001, maintained this rosy outlook.

Nevertheless, on April 6, 2001, Tellabs reduced its first quarter sales projections once again—down to $772 million from the $830 to $865 million range it had forecast just a month earlier. Notebaert cautioned that Tellabs's customers were deploying their new equipment slowly and "exercising a high degree of prudence over every dollar spent." In the face of this downward revision, Notebaert informed investors that "everything we hear from the customers indicates that . . . demand for services continues to grow." Notebaert insisted that the demand for the TITAN 6500 was "very strong" and explained that the only reason for the downward projections was that Tellabs's customers were pushing orders back from the first to the second quarter of 2001.

Less than two weeks later, Tellabs announced that sales for the first quarter were in fact $772 million. While significantly below the original projections, this still represented a 21% increase in sales over the first quarter of 2000. Nonetheless, Tellabs announced that it was abandoning one of the products it had been touting, the SALIX program, just 14 months after purchasing it for $300 million.

Despite the mixed news, analysts still thought that Tellabs was a stock worth buying. By this point, though, the company's stock price had fallen from a high of $67 per share to somewhere in the low $30 range. Over the next few months, while Tellabs's executives kept mum, the company's stock crept back up to over $38. Then, on June 19, 2001, the last day of the class period, Tellabs announced a substantial reduction in its second quarter projections. It had projected that sales would be between $780 and $820 million, but it now revealed that its second quarter revenues would amount to only $500 million. On yet another conference call, Notebaert informed investors that the reduction was almost entirely because of an enormous reduction in TITAN 5500

sales. The next day, Tellabs's stock price plunged to $15.87 per share.

On December 3, 2002, the plaintiffs filed their first complaint against Tellabs and 10 of its executives. The complaint alleged that Tellabs's executives knowingly lied to the public, in the following particular ways: (1) they had informed the market that the TITAN 6500 was available when in fact it was not; (2) they had represented that demand for the TITAN 5500 was stable or even growing when in fact they knew that it was waning; (3) they said that the SALIX line of products was bound for success when in fact Tellabs knew that it was bound to fail; (4) they portrayed Tellabs's fourth quarter revenues and earnings for 2000 as stellar when in fact they were fraudulently inflated; and (5) they announced that Tellabs's future earnings would be greater than actually expected.

The defendants moved to dismiss the complaint for failure to state a claim. The district court granted the motion, with leave to amend, finding that (1) all but one of Tellabs's projections were accompanied by meaningful cautionary language, and thus fell within the scope of the "safe harbor" provisions of the PSLRA; (2) the plaintiffs had failed to offer particularized facts to support their claim that Tellabs misrepresented its fourth quarter 2000 results; and (3) the complaint failed adequately to allege that the defendants met the scienter standard for securities fraud, which requires that they likely intended "to deceive, manipulate, or defraud." See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 & n. 12, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976).

On July 3, 2003, the plaintiffs filed a second amended complaint, bolstering their allegations with references to 27 confidential sources, shortening the list of defendants by four, eliminating a few of their weaker claims, and adding more specific scienter allegations against each of the remaining defendants. While the district court found that a number of

the statements are actionable, it nonetheless dismissed again because, it thought, the plaintiffs still had failed adequately to allege scienter for any of the defendants. The court echoed its earlier holding that the PSLRA safe harbor provision protected Tellabs's forecasts. The plaintiffs appeal, arguing that (1) some of the statements the court dismissed as "mere puffery" are legally actionable; (2) their complaint provided enough detail to support a strong inference of scienter for each of the defendants; and (3) the disclaimer accompanying Tellabs's forecasts was insufficient and therefore Tellabs could not rely on the PSLRA's safe harbor provision.

II

The plaintiffs' complaint alleges three distinct statutory violations. First, the plaintiffs contend that Tellabs, as a company, and Birck and Notebaert, as individuals, violated § 10(b) of the Securities Exchange Act of 1934, codified in 15 U.S.C. § 78j, and Securities Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. § 240.10b-5. Second, the complaint alleges that Notebaert, Birck, and two other Tellabs executives were "control persons" and therefore liable under § 20(a) of the Securities Exchange Act, 15 U.S.C. § 78(t), for the corporation's fraudulent acts. Finally, the plaintiffs allege that Birck engaged in illegal insider trading in violation of § 20A of the Act, 15 U.S.C. § 78t-1. The control person and insider-trading allegations require an underlying securities fraud violation. Because the district court rejected the plaintiffs' underlying securities fraud complaint, it also dismissed these attendant claims. We as always review the district court's decision to dismiss under Rule 12(b)(6) *de novo*, see *In re: Cerner Corp. Sec. Litig.*, 425 F.3d 1079, 1083 (8th Cir.2005), as well as its interpretation of the heightened pleading requirements of the PSLRA.

Unlike a run-of-the-mill complaint, which will survive a motion to dismiss for failure to state a claim so long as it is "possible to hypothesize a set of facts, consistent with the

complaint, that would entitle the plaintiff to relief," *Sanville v. McCaughtry*, 266 F.3d 724, 732 (7th Cir.2001) (quotation omitted), the PSLRA essentially returns the class of cases it covers to a very specific version of fact pleading—one that exceeds even the particularity requirement of Federal Rule of Civil Procedure 9(b). See, *e.g., In re: Rockefeller Center Props., Inc. Sec. Litig.*, 311 F.3d 198, 217 (3d Cir.2002) (noting that the PSLRA "imposes another layer of factual particularity to allegations of securities fraud"). Under the PSLRA, a securities fraud complaint must (1) "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed" and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(1), (2). In other words, plaintiffs must not only plead a violation with particularity; they must also marshal sufficient facts to convince a court at the outset that the defendants likely intended "to deceive, manipulate, or defraud." *Ernst & Ernst*, 425 U.S. at 194 & n. 12, 96 S.Ct. 1375. Most of the debate within the courts of appeals has concerned the second requirement: how much, in the way of factual detail in the pleadings, is sufficient to create this "strong inference" of the requisite scienter? Before we address that question, however, it is helpful to review Tellabs's actionable statements and the district court's assessment of them.

A

Passed in the 1930s in reaction to the stock market crash of 1929 and the Great Depression, the modern securities laws were designed, according to the Supreme Court, to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics

in the securities industry." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186, 84 S.Ct. 275, 11 L.Ed.2d 237 (1963). "'There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy.'" *Basic Inc. v. Levinson*, 485 U.S. 224, 230, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988) (quoting H.R.Rep. No. 1383, 73d Cong., 2d Sess., 11 (1934)). Under § 10(b) of the Securities Exchange Act and Rule 10b-5, a plaintiff can obtain damages if she can prove (1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied and (6) that the false statement proximately caused the plaintiff damages. See, *e.g., Caremark, Inc. v. Coram Healthcare Corp.*, 113 F.3d 645, 648 (7th Cir.1997).

The first pleading hurdle of the PSLRA requires the plaintiff to support with particularity the first two elements noted above: the falsity of the statement of fact or the omission, and its materiality. It is not enough simply to allege in general that the defendant's statement was false and material. Looking first at the "falsity" requirement, we see that the PSLRA requires the complaint to specify each statement that is allegedly misleading, the reasons why it is so, and, if based on information and belief, what specific facts support that information and belief. See 15 U.S.C. § 78u-4(b)(1). Although § 78u-4(b)(1) requires a complaint to state "*all* facts on which that belief is formed," this does not mean that a complaint automatically survives if it lists "all" of the facts supporting the plaintiff's belief. Nor does it mean that if the plaintiff alleges sufficient facts but leaves out a redundant detail, the court must dismiss the complaint. As the Second Circuit has held, such exactitude would render the statute meaningless:

> Reading "all" literally would produce illogical results that Congress cannot have intended. Contrary to the clearly expressed purpose of the PSLRA, it would allow

> complaints to survive dismissal where "all" the facts supporting the plaintiff's information and belief were pled, but those facts were patently insufficient to support that belief. Equally peculiarly, it would require dismissal where the complaint pled facts fully sufficient to support a convincing inference if any known facts were omitted.

*Novak v. Kasaks*, 216 F.3d 300, 314 n. 1 (2d Cir.2000). We agree with the Second Circuit that the relevant question is "whether the facts alleged are sufficient to support a reasonable belief as to the misleading nature of the statement or omission." *Id.*

Often, as is the case here, plaintiffs rely at the pleading stage on confidential sources to meet this requirement, creating yet another knotty complication. Does the identity of the plaintiffs' sources necessarily fall within the facts required to support a reasonable belief that the defendant has committed fraud? Other circuit courts have said that it does not. *California Pub. Employees' Ret. Sys. v. Chubb Corp.*, 394 F.3d 126, 146 (3d Cir.2004); *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336, 351-54 (5th Cir.2002); *In re: Cabletron Systems, Inc.*, 311 F.3d 11, 29-31 (1st Cir.2002); *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 667-68 (8th Cir.2001); *Novak*, 216 F.3d at 314. We agree with our colleagues that it would be too much to require plaintiffs to provide "name, rank, and serial number" for each of these sources. They must, however, describe their sources with sufficient particularity "to support the probability that a person in the position occupied by the source would possess the information alleged," *Novak*, 216 F.3d at 314, or in the alternative provide other evidence to support their allegations. This standard protects the privacy of the sources while still ensuring that the court has enough information to assess the soundness of the plaintiffs' allegations. A bright line rule obliging the plaintiffs to reveal their sources

has the potential to deter informants from exposing malfeasance. Such a rule might also invite retaliation. Nonetheless, plaintiffs must still provide significant detail about their informants. If the descriptions indicate that the sources would not have access to, or knowledge of, the facts underlying the allegations, the allegations would be insufficient.

Turning to the materiality requirement, we note initially that materiality depends upon the facts. It is necessary to examine "the significance the reasonable investor would place on the withheld or misrepresented information." *Basic*, 485 U.S. at 240, 108 S.Ct. 978. As the Fourth Circuit has clarified, there must be "a substantial likelihood that a reasonable purchaser or seller of a security (1) would consider the fact important in deciding whether to buy or sell the security or (2) would have viewed the total mix of information made available to be significantly altered by disclosure of the fact." *Longman v. Food Lion, Inc.*, 197 F.3d 675, 682-83 (4th Cir.1999); see also *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995) (finding that materiality exists when "there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor to have significantly altered the total mix of information"). The crux of materiality is whether, in context, an investor would reasonably rely on the defendant's statement as one reflecting a consequential fact about the company. If the statement amounts to vague aspiration or unspecific puffery, it is not material. See *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir.1997) ("Mere sales puffery is not actionable under Rule 10b-5.").

With these principles in mind, we turn to the plaintiffs' allegations against Notebaert and Birck. The plaintiffs' allegations fall into four categories: (1) statements overstating the demand for the TITAN 5500; (2) statements concerning the availability of the TITAN 6500; (3) statements regarding Tellabs's financials for the fourth quarter of 2000; and (4) statements exaggerating Tellabs's earnings and revenue pro-

jections. We begin with the question whether the complaint adequately alleged that the statements were misleading. It identifies 27 confidential sources, noting the position each held within Tellabs and the dates of each person's employment with the company. *Cf. Chubb Corp.*, 394 F.3d at 148 (finding problematic the complaint's failure to detail when the plaintiffs' confidential sources worked for the defendant). The list includes former managers and high-level executives. The descriptions provided in the complaint reveal that many of the informants were in a position to provide reliable information concerning whether Birck's and Notebaert's statements were false and material and whether Birck and Notebaert knew this to be the case.

By January 2001, the complaint asserts, demand for Tellabs's "best seller"—the TITAN 5500—was drying up. Verizon, Tellabs's largest customer, reduced its orders for the TITAN 5500 by roughly 25% in late 2000 and by roughly 50% in January 2001. Customers in Latin America and Central America were no longer buying the product. By late 2000, according to a couple of the confidential sources, Tellabs had excess TITAN 5500s on hand because of the lack of demand. One confidential source informed the plaintiffs that Tellabs paid Probe Research, an outside company, $100,000 to forecast demand for the TITAN 5500. Completed "in or about early 2001," the report showed that the market need for the TITAN 5500 was evaporating. Based on this research, Tellabs's marketing strategy department distributed an internal memorandum that concluded that revenue from the TITAN 5500 would decline by about $400 million.

Even taking into account this declining demand, we agree with the district court that some of the statements attributed to Notebaert during this time amount to no more than puffery. It is doubtful that an investor would rely on statements like "we feel very, very good about the robust growth we're experiencing," or "demand for our core optical products . . . remains

strong." These vague comments did not identify the TITAN 5500 in particular and were unlikely to induce an investor to purchase Tellabs's stock.

Other statements are more troublesome, especially when viewed against the backdrop of the company's upbeat attitude. On March 8, 2001, in response to a question from a Deutsche Bank analyst about whether Tellabs was experiencing any weakness in TITAN 5500 sales, Notebaert responded: "We're still seeing that product continue to *maintain its growth rate*; it's still experiencing strong acceptance." (Emphasis added.) In context, this went well beyond puffery: it was a direct response to an analyst's inquiry about a possible decline in TITAN 5500 sales. It is reasonable that an analyst or investor would take Notebaert at his word, and it is misleading to describe a decline as equivalent to a continued growth rate.

Similarly, in Tellabs's 2000 Annual Report, published in February 2001, Notebaert and Birck responded to a frequently asked question ("[A]re you worried that [the TITAN 5500] has peaked?") by stating flatly, "No. . . . Although we introduced the product nearly 10 years ago, it's still going strong." Perhaps in a different context this statement would amount to puffery, but its place in the "frequently asked questions" section of the Annual Report suggests that the answer was particularly important to investors. It would be reasonable for an investor to rely on the statement, believing that sales for the TITAN 5500 were "still going strong."

As with the statements pertaining to the TITAN 5500, some of the statements concerning the TITAN 6500 are not the type on which an investor would reasonably rely. Notebaert's statement, for example, that "[o]n the 6500, demand for that product is exceeding our expectations" essentially is meaningless. As one court has put it, "[i]t is hard to imagine a more subjective or vague statement than 'exceeded our expectations.' This is precisely the type of

statement that the marketplace views as pure hype, and accordingly discounts entirely." *In re Allaire Corp. Sec. Litig.*, 224 F.Supp.2d 319, 331 (D.Mass.2002).

As the district court found, however, some of Tellabs's statements regarding the TITAN 6500 crossed into the realm of material falsity. According to the complaint, the TITAN 6500 was not available for delivery until well after the class period ended. Yet on December 11, 2000, the first day of the class period, Tellabs flatly stated, "The TITAN 6500 system is available now." On March 8, 2001, Notebaert told analysts, "Interest in and demand for the 6500 continues to grow. . . . We continue to ship the . . . 6500 through the first quarter. We are satisfying very strong demand and growing customer demand." Again, on April 6, 2001, in response to an analyst's question whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter, Notebaert stated, "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." These statements are particular, specific, and, according to the complaint, completely false. The plaintiffs have alleged with sufficient particularity that some of Notebaert's statements regarding the TITAN 6500 were material and false.

The plaintiffs further allege that the defendants falsely represented Tellabs's financial results for the fourth quarter of 2000. Although the amended complaint alleges that Tellabs inflated its fourth quarter numbers through the use of fictitious sales, back-dated orders, and "creative" incentives, the only allegation that the plaintiffs pleaded with sufficient particularity is the charge that Tellabs flooded its downstream customers with unordered TITAN 5500s. This practice, known as channel stuffing, creates a short-term illusion of increased demand between the time when the company sends the extra product down the line and the time when the

distributors return the unwanted excess. According to the plaintiffs' confidential sources, Tellabs had to lease extra storage space in January and February 2001 to accommodate the large number of returns.

While there may be legitimate reasons for attempting to achieve sales earlier via channel stuffing, providing excess supply to distributors in order to create a misleading impression in the market of the company's financial health is not one of them. The complaint relies on several confidential sources to support the channel stuffing allegation. For example, one source informed class counsel that Verizon's chairman had asked Tellabs to stop providing Verizon, Tellabs's largest customer, with products that Verizon did not request or require. Given the consistency and specificity of the plaintiffs' channel stuffing allegations, the district court found, and we agree, that the amended complaint provided sufficient detail of channel stuffing to overcome the PSLRA's material falsity hurdle.

Finally, the plaintiffs identify a series of what turned out to be overstated revenue projections made by Tellabs, which, according to the complaint, were meant to induce investors to purchase Tellabs stock. The district court found that because Tellabs included disclaimers along with each of these projections, the statements fell within the PSLRA's safe harbor provision. "The statutory safe harbor forecloses liability if a forward-looking statement 'is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement.'" *Asher v. Baxter Intern. Inc.*, 377 F.3d 727, 729 (7th Cir.2004) (quoting 15 U.S.C. § 77z-2(c)(1)(A)(i)). Here, Tellabs accompanied each projection with the following statement:

> Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to,

> risks associated with introducing new products, entering new markets, availability of resources, competitive response, and a downturn in the telecommunications industry. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events.

After the district court's decision, this court decided *Asher*, 377 F.3d 727, which confronted the issue of what constitutes a "meaningful cautionary statement." In *Asher*, the defendant listed a host of consequential variables in its safe harbor disclaimer similar to those mentioned by Tellabs. The *Asher* plaintiffs argued that the defendant's disclaimer was mere boilerplate, while the defendant, Baxter International, argued that it need not provide greater detail, as the disclaimer mentioned each of its business segments. *Id.* at 732-33. We rejected both extremes:

> Plaintiffs say that Baxter's cautions were boilerplate, but they aren't. Statements along the lines of "all businesses are risky" or "the future lies ahead" come to nothing other than caveat emptor (which isn't enough); these statements, by contrast, at least included Baxter-specific information and highlighted some parts of the business that might cause problems. For its part, Baxter says that mentioning these business segments demonstrates that the caution is sufficient; but this also is wrong, because then any issuer could list its lines of business, say "we could have problems in any of these," and avoid liability for statements implying that no such problems were on the horizon even if a precipice was in sight.

*Id.* at 733. We concluded that a disclaimer falls within the safe harbor provision only if it mentions "those sources of variance that (at the time of the projection) were the principal or important risks." *Id.* at 734. Since we could not assess this

question on the pleadings and record then available to us, we remanded the case to district court.

According to the complaint, the defendants knew at the time they made the projections that demand for the TITAN 5500 was drying up and that production of the TITAN 6500 was far behind schedule. Tellabs argues that the disclaimer covered these contingencies by warning investors that a "downturn in the telecommunications industry" could affect its forecasts and that there are "risks associated with introducing new products." Without doubt, these generalized statements encompass Tellabs's troubles with the TITAN 5500 and 6500; they also encompass a whole world of other possible contingencies. The breadth of these warnings makes it impossible for us to conclude that they meaningfully described "the principal or important risks" facing Tellabs at the time it made the projections. Indeed, this level of generality exemplifies the useless *caveat emptor* boilerplate we criticized in *Asher*. See *id.* at 733. Accordingly, we find that Tellabs's warnings were not particularized enough for it to claim shelter under the PSLRA's safe harbor provision.

In sum, we agree with the district court that some of the defendants' statements regarding the TITAN 5500 and 6500 amounted to nothing more than immaterial puffery. The defendants do not contest the district court's finding that other statements made in connection with these products and the company's past results are actionable. We too conclude that this is the case. Finally, we disagree with the district court's conclusion that Tellabs was entitled to take advantage of the safe harbor; to the contrary, we find that it did not accompany its financial projections with a "meaningful cautionary statement."

B

All of this will not affect the ultimate outcome of this case, however, unless the plaintiffs can clear another, even more

arduous, hurdle: adequately alleging scienter. In passing the PSLRA, some in Congress recorded their belief that Federal Rule of Civil Procedure 9(b) had "not prevented abuse of the securities laws by private litigants." H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740. To address this perceived abuse, the PSLRA changes the threshold pleading rules by requiring that the complaint "with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

According to the Ninth Circuit, in enacting § 78u-4(b)(2), Congress also raised the substantive state of mind requirement for securities fraud allegations. See *In re Silicon Graphics Sec. Litig.*, 183 F.3d 970, 979 (9th Cir.1999) (determining that a plaintiff must allege facts that create a strong inference of "deliberate or conscious recklessness" or a "degree of recklessness that strongly suggests actual intent"). We are not persuaded by this position. Prior to the passage of the PSLRA, every circuit to consider the substantive scienter standard—including the Ninth—had held that a showing of recklessness was sufficient to allege scienter. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir.1990); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir.1989); *Van Dyke v. Coburn Enter., Inc.*, 873 F.2d 1094, 1100 (8th Cir.1989); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814-15 (11th Cir.1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir.1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir.1981) (*en banc* ); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023-25 (6th Cir.1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir.1978) (assuming without deciding that recklessness was sufficient); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir.1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir.1977). Since § 78u-4(b)(2) refers to the

"required state of mind," it seems more likely to us that Congress did not object to the substance of the state of mind standard found in the law before the passage of the Act. If Congress had wanted to impose a more stringent scienter standard, we believe that it would have done so explicitly, just as it expressly changed the pleading requirements. Save the Ninth Circuit, all other circuits to have considered this issue have concluded that the substance remained unchanged. Accordingly, we will apply the same scienter standard now as we did prior to the passage of the PSLRA: "an extreme departure from the standards of ordinary care, [ ] which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Sundstrand Corp.*, 553 F.2d at 1045 (quotation removed) (applying the standard to omissions); see also *SEC v. Jakubowski*, 150 F.3d 675, 681-82 (7th Cir.1998) (applying the *Sundstrand* scienter standard in a case decided after the passage of the PSLRA).

While § 78u-4(b)(2) did not impose a more stringent substantive scienter standard, it did unequivocally raise the bar for pleading scienter. Not only must plaintiffs meet a particularity requirement; they must also meet a substantive requirement by pleading sufficient facts to create "a strong inference" of scienter. Congress did not, unfortunately, throw much light on what facts will suffice to create such an inference. Currently three different approaches toward the way to demonstrate the required "strong inference" exist among the courts of appeals. The Second and Third Circuits take the position that the statute adopted the Second Circuit's pre-PSLRA pleading standard for scienter, "and thus plaintiffs may continue to state a claim by pleading either motive and opportunity or strong circumstantial evidence of recklessness or conscious misbehavior." *Novak*, 216 F.3d at 309-10; *In re: Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530-35 (3d Cir.1999). The Ninth and Eleventh Circuits disagree, believing that Congress considered, but ultimately rejected the

Second Circuit's approach, opting instead for a more onerous burden. See *Silicon Graphics*, 183 F.3d at 974 ("Congress intended to elevate the pleading requirement above the Second Circuit standard requiring plaintiffs merely to provide facts showing simple recklessness or a motive to commit fraud and opportunity to do so."); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir.1999) ("[B]ecause the clear purpose of the [PSLRA] was to curb abusive securities litigation, and because we believe that the motive and opportunity analysis is inconsistent with that purpose, we decline to adopt it.").

The remaining six circuits that have considered this issue take a middle ground, reasoning that "Congress chose neither to adopt nor reject particular methods of pleading scienter—such as alleging facts showing motive and opportunity—but instead only required plaintiffs to plead facts that together establish a strong inference of scienter." *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir.2003); accord *Green Tree*, 270 F.3d at 659-60 (8th Cir.2001); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 411-12 (5th Cir.2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261-63 (10th Cir.2001); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550-52 (6th Cir.2001) (*en banc* ); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-97 (1st Cir.1999). We find this position persuasive. While some legislators may have thought that they were adopting the Second Circuit's pre-PSLRA approach, others may have envisioned a stricter standard, and still others may have had yet another view. See *Advanta Corp.*, 180 F.3d at 533 (reviewing the PSLRA's legislative history and concluding that it is "contradictory and inconclusive"). In any event, "[l]egislation is an objective text approved in constitutionally prescribed ways; its scope is not limited by the cerebrations of those who voted for or signed it into law." *United States v. Mitra*, 405 F.3d 492, 495 (7th Cir.2005). The text of the statute states only that the complaint must support "a strong inference" of scienter.

Without more detailed instruction, we conclude that the best approach is for courts to examine all of the allegations in the complaint and then to decide whether collectively they establish such an inference. Motive and opportunity may be useful indicators, but nowhere in the statute does it say that they are either necessary or sufficient.

Another concern, independent of the question of what type of information will support a finding of scienter, is the degree of imagination courts can use in divining whether a complaint creates a "strong inference." The Sixth Circuit has said that "the strong inference requirement creates a situation in which 'plaintiffs are entitled only to the most plausible of competing inferences,' but that it does not mandate that the inference be 'irrefutable.'" *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir.2004) (quoting *Helwig*, 251 F.3d at 553). As the Sixth Circuit itself has hinted, however, this standard could potentially infringe upon plaintiffs' Seventh Amendment rights. See *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 399 F.3d 651, 683 n. 25 (6th Cir.2005) ("One might argue that for cases where a juror could conclude that the facts pleaded show scienter, but that conclusion would not be the most plausible of competing inferences, a Seventh Amendment problem is presented.").

While we express no view on whether the Sixth Circuit's approach is in fact unconstitutional, we think it wiser to adopt an approach that cannot be misunderstood as a usurpation of the jury's role. Instead of accepting only the most plausible of competing inferences as sufficient at the pleading stage, we will allow the complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. "Faced with two seemingly equally strong inferences, one favoring the plaintiff and one favoring the defendant, it is inappropriate for us to make a determination as to which inference will ultimately prevail, lest we invade the traditional role of the

factfinder." *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir.2003). "Scienter is normally a factual question to be decided by a jury, but the complaint must at least provide a factual basis for its scienter allegations." *Cerner Corp.*, 425 F.3d at 1084-85. If a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal; the complaint would fail as a matter of law to meet the requirements of § 78u-4(b)(2). See *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir.2003) ("We [ ] understand a 'strong inference' of scienter to be a conclusion logically based upon particular facts that would convince a reasonable person that the defendant knew a statement was false or misleading.").

The final piece of the scienter puzzle is whether the scienter allegations made against one defendant can be imputed to all other defendants in the same action. The so-called "group pleading presumption" is "premised on the assumption that in cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other 'group-published information,' it is reasonable to presume that these are the collective actions of the officers." *Bridgestone Corp.*, 399 F.3d at 689. There is significant debate among the various circuits on the question whether the group pleading doctrine survived the heightened pleading requirements of the PSLRA, see *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 364 (5th Cir.2004); *Cabletron Sys.*, 311 F.3d at 40, as well as among the district courts of this circuit. Compare *Danis v. USN Communications, Inc.*, 73 F.Supp.2d 923, 939 n. 9 (N.D.Ill.1999) (concluding that group pleading continues after the PSLRA) with *Chu v. Sabratek Corp.*, 100 F.Supp.2d 827, 835-37 (N.D.Ill.2000) (concluding that it does not). The answer, in our view, lies in the language of the statute. Section 78u-4(b)(2) requires that the complaint "state with particularity facts giving rise to a strong inference that *the defendant* acted with the required

state of mind." As the Fifth Circuit recently held, "PSLRA references to 'the defendant' may only reasonably be understood to mean 'each defendant' in multiple defendant cases, as it is inconceivable that Congress intended liability of any defendants to depend on whether they were all sued in a single action or were each sued alone in several separate actions." *Southland*, 365 F.3d at 365-66. See also *Phillips v. Scientific-Atlanta, Inc.*, 374 F.3d 1015, 1018 (11th Cir.2004) ("[W]e believe that the most plausible reading in light of congressional intent is that a plaintiff, to proceed beyond the pleading stage, must allege facts sufficiently demonstrating each defendant's state of mind regarding his or her alleged violations."). We find this reasoning persuasive. While we will aggregate the allegations in the complaint to determine whether it creates a strong inference of scienter, plaintiffs must create this inference with respect to each individual defendant in multiple defendant cases.

The district court found that the plaintiffs' complaint adequately alleged that Notebaert and Birck made false or misleading material statements in regards to the TITAN 5500, the TITAN 6500, and the company's past results. We have drawn the same conclusion with respect to Tellabs's future projections. We can now assess whether the complaint states, with respect to each of these actionable statements, facts that give rise to a strong inference of scienter. We conclude that the complaint meets this threshold for Notebaert, but not for Birck. Since Notebaert was acting within the scope of his position as CEO, his alleged knowledge of the falsity of his statements can be imputed to the corporate entity Tellabs. See *United States v. One Parcel of Land Located at 7326 Highway 45 North*, 965 F.2d 311, 316 (7th Cir.1992) ("Where a corporate agent obtains knowledge while acting in the scope of his agency, he presumably reports that knowledge to his corporate principal so the court imputes such knowledge to a corporation.").

First, as for the TITAN 5500, the Probe Research report revealed, "in or about early 2001," that the market for the TITAN 5500 had faded. In reaction to this news, Tellabs's marketing strategy department concluded that revenue from the TITAN 5500 would decline by about $400 million. According to one confidential source, a Tellabs market analyst who worked for the company throughout the class period, internal reports revealed by March 2001 that the market for the 5500 was drying up. Yet, in April 2001, Notebaert told financial analysts that "everything we hear from the customers indicates that our in-user demand for services continues to grow." While it is conceivable that Notebaert had yet to see the reports suggesting his company was in trouble ("in or about early 2001" is somewhat vague), the plaintiffs have provided enough for a reasonable person to infer that Notebaert knew that his statements were false. According to another confidential source, a Tellabs business manager, Notebaert stayed on top of the company's financial health through weekly conversations with his fellow executives. Given the significance of the TITAN 5500 and the number of reports suggesting that it was in trouble, we find it sufficiently probable that Notebaert had information suggesting that his statements were false. See *Green Tree*, 270 F.3d at 665 ("One of the classic fact patterns giving rise to a strong inference of scienter is that defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate.").

Creating the required strong inference that Birck knew about the 5500's market weakness is more difficult. On the one hand, he signed a letter in February 2001 informing investors that the 5500 was "still going strong." Plaintiffs also alleged generally that he regularly attended "town hall meetings" with Notebaert, that he (with Notebaert) had his "hands on the pulse," and that he knew the status of each product. Furthermore, Birck sold 80,000 Tellabs shares in the first week of February 2001, which the plaintiffs suggest

supplies circumstantial evidence that he knew that his February statement was false. On the other hand, undermining the inference of Birck's knowledge is the fact that it was not until March 2001 that the TITAN 5500's declining status was obvious, and Birck's last public comment regarding the 5500 was that February letter. This particular insider trading evidence also adds little to the overall picture. While insider trading may be sufficient circumstantial evidence of scienter, plaintiffs must show that the sale of stock is "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *Silicon Graphics*, 183 F.3d at 986 (internal quotation omitted); see also *Cerner Corp.*, 425 F.3d at 1085. Here, the plaintiffs allege that Birck made a significant stock sale, but the complaint provides no information as to how this sale compared to Birck's past or subsequent trading. Indeed, while 80,000 shares may be a lot of shares, it represented only one percent of Birck's holdings. The complaint does not provide any reference point from which to judge Birck's sales, and we do not believe that the mere fact that he sold one percent of his stock necessarily establishes a strong inference of scienter. Finally, the complaint fails to allege with particularity that Birck made any actionable statements regarding the TITAN 6500.

While we consider it a close question, we conclude that the plaintiffs did not meet the strict PSLRA standards for pleading Birck's scienter. We thus confine the remainder of our scienter discussion with respect to the 6500 to Notebaert. According to the complaint, Notebaert made a number of false statements regarding the 6500, suggesting that it was available and being shipped, when, in fact, Tellabs did not ship a single TITAN 6500 during the class period. If it is true that the TITAN 6500 was not in fact available during the class period, it is hard to accept that Notebaert's statements were simply honest mistakes. According to a Tellabs sales director, Notebaert saw weekly sales reports and production

projections. Another confidential source, a former high-level sales executive, reported that Notebaert knew that "the TITAN 6500 was not ready for deployment despite Tellabs'[s] public announcements." We conclude that the plaintiffs have pleaded sufficient facts to "giv[e] rise to a strong inference," 15 U.S.C. § 78u-4(b)(2), that Notebaert knowingly lied when he informed investors that the 6500 was "available now" and was "being shipped."

Although both Birck and Notebaert signed Tellabs's 10-K for the fourth quarter of 2000, once again the complaint does not contain enough information to create a strong inference that Birck recklessly disregarded the truth of Tellabs's financial health. According to the complaint, Tellabs fabricated the appearance of demand through channel stuffing. Although Birck should have assured himself that the numbers being represented were accurate, his trust in his CEO does not constitute the level of recklessness that the statute requires. The plaintiffs do, however, allege sufficient facts to suggest that Notebaert was aware of the channel stuffing. Indeed, a former senior business manager at Tellabs informed the plaintiffs that Notebaert "worked directly with Tellabs'[s] sales personnel" to effect the channel stuffing. Another confidential source, a high-level sales executive, admitted that his employees fabricated purchase orders for products that customers had not ordered. He claimed that Notebaert "unquestionably knew" about the channel stuffing. As with the TITAN 5500 and 6500, we find that the complaint contains enough detail to establish a strong inference that Notebaert knew of the channel stuffing and therefore knew Tellabs had exaggerated its fourth quarter 2000 revenues.

Finally, since the allegedly overstated revenue projections rest on the company's statements that its products were doing better than they actually were, the scienter for those alleged misrepresentations serves as sufficient circumstantial evidence of scienter here. Thus, the complaint is sufficient to

state a claim that Notebaert, but not Birck, recklessly disclosed overstated projections.

III

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 impose liability not only on the person who actually commits the securities law violation, but also on the persons who "directly or indirectly" control the violator. See 15 U.S.C. § 78t(a). Thus, the plaintiffs' claims against Notebaert, Birck, and the other Tellabs executives for controlling person liability under § 78t(a) survive because the complaint adequately alleges a complaint against Tellabs, a "person" these individuals allegedly controlled. See *In re Stone & Webster, Inc. Sec. Litig.*, 424 F.3d 24, 27 (1st Cir.2005) (holding that "it is an essential element of the § 20(a) controlling person claims [in that case] . . . that plaintiffs show a Rule 10b-5 violation by the controlled entity"). While this is something of a back door to liability, given our finding that the complaint adequately alleges only that Notebaert acted with scienter, § 78t(a) allows a defendant to nullify control person liability by proving that he acted in "good faith." If, in the end, the plaintiffs are able to sustain a charge against Tellabs, Birck and the other executives will have an opportunity to prove that they acted in good faith.

The plaintiffs also pleaded a claim against Birck for insider trading. A private cause of action exists under § 20A of the Securities Exchange Act against persons who purchase or sell a security "while in possession of material, nonpublic information." See 15 U.S.C. § 78t-1(a). To create potential liability under § 20A, the plaintiffs must prove an independent violation of "this chapter or the rules or regulations thereunder." *Id.* In other words, § 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act." *Advanta Corp.*, 180 F.3d at 541. At this point in the litigation, we have affirmed the dismissal of the underlying securities fraud claims pleaded directly against

Birck. He still faces liability, but solely as a control person under § 20(a). Whether § 20(a) control-person liability standing alone can serve as the "separate underlying violation" required for § 20A insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum. No party in this litigation has provided more than cursory briefing of this issue, and therefore we take no position on its resolution, leaving it for further factual and legal development during the course of the litigation.

## IV

For these reasons, we AFFIRM in part and REVERSE in part the judgment of the district court, and REMAND for further proceedings consistent with this opinion.

**APPENDIX B**

UNITED STATES DISTRICT COURT
N.D. ILLINOIS
EASTERN DIVISION

No. 02 C 4356

THOMAS JOHNSON,

*Plaintiff,*

v.

TELLABS, INC., MICHAEL J. BIRCK, RICHARD C. NOTEBAERT, ROBERT W. PULLEN, JOAN E. RYAN, BRIAN JACKMAN and JOHN C. KOLHER,

*Defendants.*

Feb. 19, 2004

*MEMORANDUM OPINION AND ORDER*

ST. EVE, *District Judge.*

Defendants have moved to dismiss the Second Amended Complaint pursuant to Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. Their motion is granted.

This putative class action lawsuit is brought by various plaintiffs individually and on behalf of persons who purchased common stock of Defendant Tellabs between December 11, 2000 and June 19, 2001 (the "Class Period"). Plaintiffs[1] brought this purported class action alleging that Defendants engaged in a scheme to deceive and defraud

[1] On September 27, 2002, the Court appointed Makor Issues & Rights ("Makor Issues") Lead Plaintiff pursuant to 15 U.S.C. § 78u-4. *See Johnson v. Tellabs, Inc.*, No. 02 C 4356, 2002 WL 31163670 (N.D.Ill. Sept. 27, 2002).

investors as to the true value of Tellabs, Inc.'s ("Tellabs") common stock during the Class Period. Plaintiffs contend that Defendants carried out this scheme, in part, by falsely assuring investors about Tellabs' performance and prospects, engaging in fraudulent practices to artificially boost Tellabs' revenues and conceal the rapidly falling demand for Tellabs' products, selling shares of Tellabs' common stock at artificially inflated prices, and making false and misleading misrepresentations about Tellabs' current financial condition. Plaintiffs allege that these deceptive actions resulted in the artificial inflation of Tellabs' stock price which reached a high of $67.125 per share on February 5, 2001. Plaintiffs claim that they were injured when they purchased Tellabs' common stock at these artificially inflated prices.

On May 19, 2003, this Court granted Defendants' motion to dismiss Plaintiffs' Consolidated Amended Complaint in its entirely. *See Johnson v. Tellabs, Inc.*, 262 F.Supp.2d 937 (N.D.Ill.2003) (the "*May 19, 2003 Opinion*"). Plaintiffs filed their Second Amended Class Action Complaint (the "SAC") on July 11, 2003. Unlike their Amended Complaint, Plaintiffs' SAC identifies 27 confidential sources ("CS") who support various allegations.

In their SAC, Plaintiffs did not name the following individuals who were named in the Consolidated Amended Complaint: J. Thomas Gruenwald, Catherine Kozik, William F. Souders, and John Vaughn. Defendants now seek to dismiss the SAC in its entirety for failure to state a claim upon which relief can be granted pursuant to Federal Rule of Civil Procedure 12(b)(6), for failure to plead fraud with particularity pursuant to Federal Rule of Civil Procedure 9(b), and for failure to meet the pleading standards set forth in the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) (the "PSLRA"). Given the additional detail added to the SAC and the extended analysis necessary to address this detail, the Court will repeat some of the facts set forth in its *May 19, 2003 Opinion*.

## ALLEGATIONS

### I. The Parties

Defendant Tellabs is a Delaware corporation with its principal place of business in Lisle, Illinois. (R. 63-1, SAC ¶ 16.) Tellabs designs, manufactures, markets, and services highly specialized optical networking, broadband access, and voice quality enhancement solutions. (*Id.* ¶ 2.) It is a global supplier of networking solutions and services that support the Internet. Tellabs' customers included exchange carriers, telephone companies, local telephone administrations, original equipment manufacturers, cellular and other wireless service companies, cable operators, alternate service providers, internet service providers, system integrators, government agencies, and business end-users. (*Id.* ¶ 2.) SBC Communications, Inc. ("SBC") and Verizon Communications, Inc. ("Verizon") were two of Tellabs' large customers. (*Id.* ¶ 2.)

The individual Defendants include: Michael Birck, Brian Jackman, John Kohler, Richard Notebaert, Robert Pullen and Joan Ryan (collectively, the "Individual Defendants"). Each of the Individual Defendants was an officer and/or director of Tellabs. Michael Birck, a founder of the company, was a director and served as chairman of Tellabs' board of directors since September 18, 2000. (*Id.* ¶ 17.) He also served as chief executive officer and president of Tellabs from 1975 through 2000. (*Id.*) Brian Jackman was a director of Tellabs and served as president of global systems and technology and executive vice president from 1998 through 2001. (*Id.* ¶ 18.) John Kohler was a senior vice president of global business operations from February 2000 to March 10, 2003, and a vice president of global manufacturing from 1992 through 2000. (*Id.* ¶ 19.)

Richard Notebaert served as a Tellabs' director from April 19, 2000 to June 17, 2002, and served as chief executive officer and president of Tellabs from September 18, 2000 to

June 17, 2002. (*Id.* ¶ 20.) Robert Pullen was a senior vice president and general manager of optical networking from August 2000 to February 2, 2002. (*Id.* ¶ 21.) Joan Ryan served as Tellabs' executive vice president and chief financial officer from February 2, 2000 to February 7, 2003. (*Id.* ¶ 22.)

Plaintiffs' SAC focuses on three of Tellabs' products: the TITAN 5500, the TITAN 6500 and the SALIX 7600. All of these products are complex transmission systems utilized with optical networking systems. The TITAN 5500, Tellabs' "flagship" optical networking system, is a digital cross-connect system that "help[s] direct different types of communications traffic across wired and wireless networks." (*Id.* ¶ 30.) The TITAN 6500 is a multi-service transport switch which is "capable of simultaneously transporting a variety of signal types." (*Id.* ¶ 31.) The SALIX 7600 is a switch "that enables service providers to move voice traffic seamlessly onto data networks while supporting voice services such as there-way calling and messaging." (*Id.* ¶ 32.)

II. Alleged Problems with Specific Products

Plaintiffs allege that the internet and telecommunications sectors suffered a significant decline in demand for their products in mid-2000. (*Id.* ¶ 3.) As a result, Tellabs' customers "were suffering from a severe deterioration and consolidation of their businesses." (*Id.* ¶ 4.) Given this decline, Plaintiffs allege that demand for Tellabs' products decreased. (*Id.* ¶¶ 3, 4.) Plaintiffs contend, however, that Defendants disguised the impact this decline had on Tellabs and falsely assured investors that Tellabs' performance was strong.

Plaintiffs allege that contrary to Defendants' public representations during the Class Period, the demand for the TITAN 5500—Tellabs' "best seller"—substantially slowed. (*Id.* ¶¶ 34-45.) Verizon and other clients significantly reduced their orders for the product. (*Id.* ¶¶ 35, 37.) As a result, in late 2000 and early 2001, Tellabs had "tons" of excess TITAN 5500s stored in a warehouse. (*Id.* ¶ 45.)

Similarly, Plaintiffs allege that the TITAN 6500 failed to sell as Tellabs had represented. (*Id.* ¶¶ 46-53.) They contend that Defendants touted a $100 million Sprint deal for the TITAN 6500 in order to foster a false impression that there was a demand for the product. (*Id.* ¶ 54.) Plaintiffs allege that Sprint entered this contract to satisfy an existing $100 million commitment to Tellabs, and that Sprint did not intend to purchase any TITAN 6500s beyond those in the agreement. (*Id.* ¶ 55.) Plaintiffs further contend that the TITAN 6500 was far behind schedule and not ready for release during the Class Period, was failing customer lab evaluations, and was inferior to other products offered by Tellabs' customers. (*Id.* ¶ 74.)

Plaintiffs also allege that the SALIX technology had serious technical defects and thus Tellabs could not commercialize it. (*Id.* ¶¶ 56-61.) They allege that Defendants "glowingly portrayed Tellabs' supposed 'launch' of its new 'leading edge' SALIX technology in 2000 when, in fact, the SALIX technology was both unfinished and outmoded." (*Id.* ¶ 56.) Plaintiffs contend that Defendants' statements regarding the prospects for the SALIX technology were false and misleading because they knew the SALIX technology was outmoded and could not be commercialized.

III. Allegedly False Statements by Tellabs

Plaintiffs claim that beginning on December 11, 2000 through the purported Class Period, Defendants made a series of false statements and omissions regarding Tellabs' fourth quarter 2000 financials, Tellabs' products, and its future prospects that resulted in the artificial inflation of Tellabs' stock price. Plaintiffs allege that the Individual Defendants are responsible for each of the statements.

A. December 2000

Tellabs issued a press release on December 11, 2000—the start of the purported Class Period—announcing a multi-year

sales agreement with Sprint for the TITAN 6500. "The agreement is expected to be valued at more than $100 million over the life of the contract." (*Id.* ¶ 73.) The press release noted that the "TITAN 6500 system is available now." On December 11, 2000, Tellabs also held a conference with securities analysts. On December 12, 2000, securities analysts summarized the conference and issued positive research reports on Tellabs. According to UBS Warburg, "Tellabs maintained its guidance for 4Q 2000 and all of 2001. In doing so, the company indicated that the demand for its Titan 5500 product line remain [sic] solid in 4Q and there is visibility for at least two years (if not more) of ongoing good growth for the product." (*Id.* ¶ 77.) It also estimated thirty-percent growth in sales for 2001. ABN AMRO reported Defendant Pullen commenting that "the TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (*Id.*) Baird & Co. reported that Tellabs "reiterated its confidence in the telecom-spending environment" and "reconfirmed consensus growth forecasts for fourth quarter 2000 and 2001." (*Id.* ¶ 76.) Notebaert, according to Baird & Co., "outlined the tremendous opportunity for Tellabs in international markets, as well as the expected continuing growth of the TITAN 5500, as well as its new optical-networking and next-generation switching initiatives." (*Id.* ¶ 76.)

B. January 23, 2001 Press Release

On January 23, 2001, Tellabs issued a press release announcing its financial results for the fourth quarter of 2000. (*Id.* ¶ 81.) Tellabs reported that "strength in Tellabs' core business drove record sales and earnings in the fourth quarter of 2000. Fourth-quarter 2000 sales totaled $1,018 million, up 42% from $716 million in 1999." (*Id.*) Notebaert explained, "[t]o keep up with robust growth in communications traffic, customers are buying more and more Tellabs equipment—fueling our records [sic] results and our first $1 billion

quarter." (*Id.*) The press release also reiterated Tellabs' $100 million multi-year agreement with Sprint to supply the TITAN 6500 system.

During a teleconference with securities analysts that same day, Notebaert stated: "[t]his was a great quarter and fitting end to a wonderful year.[2] Tellabs not only achieved record sales and profits in the fourth quarter [of 2000], we also set the stage for sustained growth with the successful launches of several products, many of those long anticipated . . . . Customers are embracing our products. We announced a $100 million plus agreement with Sprint for the 6500." (*Id.* ¶ 82.)

Notebaert also commented on the TITAN 6500. Specifically, he said that "[o]n the 6500, demand for that product is exceeding our expectations . . . . Demand is just . . . huge for this product." (*Id.* ¶ 84.) In an interview with Eric Schatzker from the Bloomberg News, Notebaert also commented: "I'm a little surprised at the performance of our stock the last few weeks, because last quarter, this quarter, we've been solid and we feel very, very good about the robust growth we're experiencing." (*Id.* ¶ 60.)

C. January 30, 2001 Press Release

Tellabs issued another press release on January 30, 2001, announcing "a new suite of softswitches, the SALIX 7600 softswitch control suite." (*Id.* ¶ 88.) The press release noted, "[w]ith the new SALIX 7600 suite, Tellabs has redefined the softswitch market and can now offer integrated, comprehensive solutions to all carriers." (*Id.*)

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[2] Defendant Joan Ryan also projected that "Tellabs will continue to sustain our strong record of growth" during the conference call. The Court previously dismissed this projection as protected by the PSLRA's safe harbor. *Tellabs*, 262 F.Supp.2d at 952.

D. February 14, 2001—Tellabs' 2000 Annual Report

On February 14, 2001, Tellabs issued its 2000 Annual Report. Notebaert and Birck issued a letter to stockholders in connection with the issuance of the Annual Report. (*Id.* ¶ 90.) In the letter, Notebaert and Birck represented that "Tellabs' growth is robust." (*Id.*) They stated that the TITAN 5500 continued with accelerating growth. They also stated that the TITAN 6500 "emerged from our laboratories in 2000, and customers are embracing it." Notebaert and Birck also stated that the TITAN 5500 is "still going strong," and the SALIX 7750 has a lot of opportunities. (*Id.* ¶ 91.)

The Tellabs' 2000 Annual Report contained a "Management Statement of Financial Responsibility," signed by Birck, Notebaert and Ryan. (*Id.* ¶ 94.) In that Statement, they represented that the "financial statements of Tellabs, Inc. and Subsidiaries have been prepared under the direction of management in conformity with generally accepted accounting principles." (*Id.* ¶ 94.)

E. March 2001

On March 7, 2001, Tellabs issued a press release announcing that it was lowering its revenue and earnings per share expectations for the first quarter 2001.[3] It noted that Tellabs could not recognize revenue from TITAN 6500 shipments in the first quarter but expected to do so in the second quarter of 2001. (*Id.* ¶ 99.) The press release stated that "[g]rowth in Tellabs' core optical networking business remains strong." (*Id.*)

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[3] The Court previously dismissed the projections in this press release as not actionable because they are protected by the PSLRA's safe harbor. *Tellabs*, 262 F.Supp.2d at 953. The Court also dismissed Notebaert's March 8, 2001 statement to analysts that "[w]e are as confident as ever—that may be an understatement—about the 6500" as puffery. *Id.* at 951.

During the conference call with securities analysts on March 8, 2001, Defendant Jackman explained, "[t]here's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty." (*Id.* ¶ 101.) With respect to the TITAN 5500, Notebaert told analysts "[w]e're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (*Id.* ¶ 102.) When an analyst inquired about Tellabs' reaction regarding the lowered expectations of some of its competitors, Notebaert responded "we haven't gotten any indication, I haven't gotten any indication from any of our major clients, major customers, of a downturn in the segment we're in." (*Id.* ¶ 103.)

On March 29, 2001, Tellabs issued its 10-K for 2000[4], signed by Defendants Birck, Notebaert, Ryan and Jackman. The report noted: "[t]he Company achieved record levels in sales ($3,387.4 million), net earnings ($730.8 million) and earnings per share ($1.75)—putting it on track to meet its objective of $6 billion in annual revenues by the year 2003." (*Id.* ¶ 107.) It also stated that "[t]he growth in optical networking product sales was a result of continued strong demand for the Company's TITAN 5500/5500S and TITAN 532L digital cross connect systems." (*Id.* ¶ 109.)

The Form 10-K also favorably discussed the SALIX technology. (*Id.* ¶ 108.) "Leading the growth will be the Company's SALIX 7000 family of next-generation switching products." (*Id.* ¶¶ 107, 109.)

F. April 6, 2001

On April 6, 2001, Tellabs issued a press release lowering its first quarter earnings guidance. The press release stated,

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[4] The Court previously held that the projection contained in the 10-K regarding sales growth in 2001 is protected by the PSLRA's safe harbor. *Tellabs*, 262 F.Supp.2d at 952.

"[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." (*Id.* ¶ 113.)

On April 6, 2001, Notebaert and Ryan held a conference call with securities analysts. (*Id.* ¶ 114.) During the call, Notebaert told analysts that "[i]n just the last few weeks" Tellabs had experienced "a more controlled order of flow from our larger customers." (*Id.* ¶ 114.) He noted, however, that "everything we hear from the customers indicates that our in-user demand for services continues to grow." (*Id.* ¶ 114.) Notebaert added, "[t]he good news is, orders weren't canceled, they were pushed out into the next quarter." (*Id.* ¶ 116.) He stated that "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." (*Id.* ¶ 117.) Ryan told analysts that "we see first quarter revenue of approximately $772 million, which represents a 21% year-over-year growth in overall revenue." (*Id.* ¶ 115.)

G. April 18, 2001

On April 18, 2001, Tellabs issued a press release announcing its first quarter financial results for the period ending March 31, 2001, and modified its revenue projections for 2001 from $3.99 billion to within the range of $3.6 billion to $3.7 billion. Tellabs further announced that it would "further reduce discretionary spending, eliminate salary increases this year, institute a pay-cut for all corporate officers, align manufacturing capability with demand expectations, and terminate the SALIX next-generation-switching product effort." (*Id.* ¶ 121.) It also announced that it planned to reduce its workforce by approximately 550 people. (R. 49-1, Defs.' Mot. to Dismiss App. Ex. 18.) Finally, Tellabs stated that it was terminated the SALIX next-generation switching product effort. (R. 63-1, SAC ¶ 121.) Notebaert nevertheless

stated, "I am as confident as ever in Tellabs' long-term prospects and our ability to deliver strong revenue and earnings growth in the future." (*Id.* ¶ 121.)

H. May 2001

Tellabs filed its Form 10-Q for the period ending March 30, 2001 on May 8, 2001. In the Form 10-Q, Tellabs stated that it had "achieved record first quarter 2001 sales of $772.1 million." Tellabs stated that the TITAN 5500/5500s drove the sales. (*Id.* ¶ 124.)

On May 31, 2001, Tellabs announced that it planned to take a $262 million restructuring charge in the second quarter of 2001. (*Id.* ¶ 128.) $93 million of the charge was related to the Company's termination of the SALIX next-generation switching business. (*Id.* ¶ 128.)

I. June 2001[5]

On June 19, 2001, which is the close of the purported Class Period, Tellabs issued a press release revising its second quarter guidance and reducing its revenues by approximately $300 million to $500 million. (*Id.* ¶ 131.) The press release explained the following:

> "The dramatic changes affecting the landscape of the telecommunications marketplace have continued to impact Tellabs. Service providers . . . are only buying equipment to meet the immediate needs of their customers. 'While we continue to see caution from our customers in the place of equipment deployment, our market position remains intact, and we are focused on

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[5] The Court previously held that Plaintiff had not alleged anything false about a press release issued on June 5, 2001 regarding the TITAN 6500. *Tellabs*, 262 F.Supp.2d at 951. Plaintiffs still do not particularize anything false about the release which generally discusses the TITAN 6500 and notes that it uses "the most innovative cell-based switching fabric with electrical and optical capabilities for converged services." (R. 63-1, SAC ¶ 129.)

> ensuring the most profitable path through the current environment,' said Tellabs President and CEO Richard C. Notebaert."

*Id.* Tellabs common stock fell from a high of $21.20 per share on June 19, 2001 to a low of $15.87 per share on June 20, 2001. (*Id.* ¶ 135.) The stock closed at $16.04 on June 20, 2001. (*Id.* ¶ 135.) The June 20, 2001 price reflected a decline of more than 75% "from the Class Period high of $67.125." (*Id.* ¶ 135.)

IV. Stock Sales

Plaintiffs allege that Defendants Birck, Kohler and Kozik sold approximately 150,000 shares Tellabs' common stock at artificially inflated prices during the purported Class Period, and received proceeds in excess of $8,000,000 from their sales. During the Class Period, Plaintiffs claim that Birck sold 80,000 shares for $5,183,150; Kohler sold 7,500 shares for a net profit of $466,218.75; and Kozik sold 3,220 shares for a net profit of $67,783.25. (*Id.* ¶ 144.)

## ANALYSIS

The SAC contains seven counts. Plaintiff "inadvertently" named two unnamed defendants in Counts VI and VII. (R. 78-1, Pls.' Opp. to Motion to Dismiss, p. 39 n. 32.) Accordingly, the Court dismisses Counts VI and VII. Count I alleges that Defendants violated Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5, which caused Plaintiffs and other class members to suffer damages in connection with the purchase of Tellabs stock during the class period. They allege that Defendants disseminated materially false and misleading statements and concealed material adverse facts about Tellab's financial condition and future prospects in order to deceive the investing public as to the true value of Tellabs' stock and to cause Plaintiffs to purchase Tellabs' stock at artificially inflated prices.

Count II alleges that the Individual Defendants are "control persons" who violated Section 20(a) of the Exchange Act. Count III, brought on behalf of the LeBrun-Leehey Subclass[6], alleges that Birck and Kohler violated Section 20A of the Exchange Act by insider trading. Count IV, brought on behalf of the Broholm Subclass[7], alleges that Birck violated Section 20A of the Exchange Act. Finally, Count V, brought by Plaintiff Morris on behalf of the Morris Subclass[8], also alleges that Birck violated Section 20A of the Exchange Act. Defendants have moved to dismiss the Complaint in its entirety with prejudice.

As an initial matter, Plaintiffs raise multiple arguments in their opposition to Defendants' motion that the Court ruled on in its *May 19, 2003 Opinion.* To the extent Plaintiffs ask the Court to reconsider its prior rulings, "[m]otions for reconsideration serve a limited function: to correct manifest errors of law or fact or to present newly discovered evidence." *Publishers Resource, Inc. v. Walker-Davis Publications, Inc.*, 762 F.2d 557, 561 (7th Cir.1985) (quotation omitted); *see also In re Oil Spill by "Amoco Cadiz" Off Coast of France on March 16, 1978*, 794 F.Supp. 261, 267 (N.D.Ill.1992) ("[M]otions to reconsider are not at the disposal of parties who want to 'rehash' old arguments.").

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[6] The purported LeBrun-Leehey Subclass consists of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendants Birck and Kohler on February 2, 2001 (R. 63-1, SAC ¶ 173a.)

[7] The purported Broholm Subclass consists of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendant Birck on February 5, 2001. (*Id.* ¶ 173b.)

[8] The purported Morris Subclass consists of all Class members who purchased Tellabs common stock contemporaneously with sales of Tellabs common stock by Defendant Birck on February 6, 2001. (*Id.* ¶ 173c.)

Motions to reconsider are not appropriate vehicles to advance arguments already rejected by the Court or new legal theories not argued before the ruling. *Scharlte v. Motorola, Inc.*, No. 93 C 5508, 1994 WL 323281, at *1 (N.D.Ill. June 24, 1994). Plaintiffs have not provided the Court with any reason to revisit its prior rulings here.

I. Legal Standard

The purpose of a motion to dismiss pursuant to Rule 12(b)(6) is to test the legal sufficiency of a complaint, not the merits of the case. *See Triad Assocs., Inc. v. Chicago Hous. Auth.*, 892 F.2d 583, 586 (7th Cir.1989). When considering a motion to dismiss, the Court considers "whether relief is possible under [any] set of facts that could be established consistent with [the] allegations." *Bartholet v. Reishauer A.G. (Zurich)*, 953 F.2d 1073, 1078 (7th Cir.1992). The Court views the complaint "in the light most favorable to the plaintiff, taking as true all well-pleaded factual allegations and making all possible inferences from those allegations in his or her favor." *Lee v. City of Chicago*, 330 F.3d 456, 459 (7th Cir.2003). *See also Thomas v. Law Firm of Simpson & Cybak*, 354 F.3d 696, 697 (7th Cir.2004). The Court is not, however, "obliged to accept as true legal conclusions or unsupported conclusions of fact." *Hickey v. O'Bannon*, 287 F.3d 656, 658 (7th Cir.2002).

II. Securities Fraud Pleading Requirements

Allegations of securities fraud must meet the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) as well as the strict pleading mandates of the PSLRA. Rule 9(b) requires Plaintiffs to plead "the circumstances constituting fraud . . . with particularity." *In re HealthCare Compare Corp. Sec. Litig.*, 75 F.3d 276, 281 (7th Cir.1996). As this Court previously noted, "this means the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir.1990).

A. The PSLRA's Heightened Pleading Requirements

In order to meet the PSLRA's dictates for a securities fraud claim, "the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).[9] The PSLRA also strengthened the pleading requirements for scienter in a securities fraud case: "In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). If a complaint failed to meet either of these requirements under the PSLRA, the Court "shall, on the motion of any defendant, dismiss the complaint." 15 U.S.C. § 78u-4(b)(3)(A). "Congress enacted this more stringent pleading standard 'to curtail the filing of meritless lawsuits' and to create a uniform pleading standard among the circuits." *Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 343, (4th Cir.2003), quoting H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 740.

B. Pleading on Information and Belief

The PSLRA does not require Plaintiffs to plead all of their evidence or try their case at the pleading stage. The PSLRA requires that where allegations are based on "information and belief," "the complaint shall state with particularity all facts upon which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

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[9] The PSLRA also raised a plaintiff's pleading requirement for scienter, *see* 15 U.S.C. § 78u-4(b)(2), as the Court discusses *infra* in Section III.B.

In its *May 19, 2003 Opinion*, the Court adopted the Second Circuit's approach articulated in *Novak v. Kasaks*, 216 F.3d 300, 313-14 (2nd Cir.2000), to information and belief pleading. The Court noted that "where plaintiffs rely on confidential sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." *Id.*, 216 F.3d at 314. The facts alleged in the complaint must be "sufficient to support a reasonable belief as to the misleading nature of the statement or omission." *Id.* at 314 n. 1. *See also In re Cabletron Sys., Inc.*, 311 F.3d 11, 29 (1st Cir.2002) ("The approach we take, similar to *Novak*, is to look at all of the facts alleged to see if they provide an adequate basis for believing that the defendants' statements were false.") (internal quotation marks omitted). Thus the Court will evaluate whether the factual allegations particularize and support Plaintiffs' allegations that fraud occurred.

In evaluating the allegations based on confidential sources, the Court will assess the reliability of each source's information based, in part, on the confidential source's position at Tellabs, the time period such he held such a position, his access to information and whether the allegations are based on his personal belief. The disclosure of information regarding confidential sources may be "helpful in distinguishing whether a particular allegation is mere rumor and speculation or whether it is based on concrete information from relevant documents or people who were in a position to know the truth of the allegations." *Adams v. Kinder-Morgan, Inc.*, 340 F.3d 1083, 1101 (10th Cir.2003).

Plaintiffs challenge the Court's holding and suggest that because their allegations are "based upon the investigation of Plaintiffs' counsel"—as opposed to based on information and belief—that their complaint need not state with particularity the facts on which their beliefs are formed. (R. 78-1, Opp. p. 5 n. 10). Plaintiff, however, makes a distinction without a

difference, however. Federal Rule of Civil Procedure 11 requires counsel to investigate all claims before filing a complaint, even those based on information and belief. Fed.R.Civ.P. 11(b). This Court rejects Plaintiffs' position and finds that allegations based upon counsel's investigation must state facts with the same particularity as if the claims were based on information and belief. As the Tenth Circuit recently noted, "For this court to rule otherwise would elevate form over substance and allow plaintiffs to avoid the [PSLRA]'s mandate merely by cloaking with a license to practice law the information and belief on which a complaint is based. Rule 11 of the Federal Rules of Civil Procedure provides that, by presenting a pleading, motion, or other paper to a court, an attorney is certifying that he has conducted 'an inquiry reasonable under the circumstances.'" *Adams*, 340 F.3d at 1098.

C. Group Pleading

In its *May 19, 2003 Opinion*, the Court addressed the applicability of the group pleading doctrine since the enactment of the PSLRA. As previously held, the group pleading doctrine does not survive with respect to allegations of scienter. *Tellabs*, 262 F.Supp.2d at 954. Instead, Plaintiffs must make specific allegations regarding each Defendant's scienter. *Id.*

With respect to the alleged misrepresentations made by Defendants, the Court noted that "[i]t is not entirely clear what effect the PSLRA has on the group pleading doctrine with respect to holding individual defendants" liable for statements by the company. Even if the group pleading doctrine survives the PSLRA in some form, however, it is apparent that the statute requires Plaintiffs to allege facts that support an inference that the statement is attributable to individual defendants. The PSLRA obligates a plaintiff to allege specific facts as to each of the defendant's mis-

representations or omissions. *Id.* at 946 (citing 15 U.S.C. § 78u-4(b)(1)).

III. Forward-Looking Statements

In its *May 19, 2003 Opinion*, the Court dismissed the majority of Plaintiffs' claims regarding Tellabs' revenue projections because the PSLRA's safe harbor affords protection to such projections. *Tellabs*, 262 F.Supp.2d at 952-954. Namely, the Court held that these forward-looking statements were "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." *Id.*, citing 15 U.S.C. § 78u-5(c)(1)(A)(i) & (ii). Plaintiffs' attempts to resurrect these same projection allegations in their SAC fail. The Court has already rejected these arguments and Plaintiffs have failed to provide any reason for the Court to reconsider its May 19, 2003 ruling. The Court's prior ruling stands with respect to the forward-looking statements made on January 23, 2001, March 7, 2001, March 29, 2001, April 6, 2001, and April 18, 2001. These claims are protected by the PSLRA's safe harbor and therefore are dismissed with prejudice.[10]

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[10] Plaintiffs claim that the safe harbor is inapplicable because these statements were made with actual knowledge of their falsity. Other courts have rejected this argument. *See Miller v. Champion Enterprises, Inc.*, 346 F.3d 660, 672 (6th Cir.2003) (state of mind is "irrelevant" for forward-looking statements accompanied by meaningful cautionary language); *In re Compuware Sec. Litig.*, No. 02-73793, 2004 WL 231464, at *7 (E.D.Mich. Feb.3, 2004) (same); *Sandmire v. Alliant Energy Corp.*, 296 F.Supp.2d 950 (W.D.Wis.2003) ("Such knowledge and the state of mind of the defendants at the time the statement was made are irrelevant to a safe harbor defense based on cautionary language"). Given that Plaintiffs have failed to plead a strong inference of actual knowledge, the Court need not decide this issue.

A. The December 12, 2000 Revenue Projection

The Court, however, did not reach this conclusion with respect to Tellabs' projection of 30% growth for 2001 made during a December 12, 2000 analyst call because the parties did not provide a transcript of that conversation for the Court to analyze whether any cautionary statements were made at the time of the projection. Defendants have still failed to provide such a transcript. Defendants argue that the Court nonetheless should dismiss this projection because Plaintiffs' allegations do not support that the projection was unreasonable when made.[11] The Court therefore proceeds to an analysis of scienter with respect to this statement.

B. Scienter for Forward-Looking Statements

In order for projections to be actionable, Plaintiffs must allege that Defendants made them with "the knowledge that they are incorrect or are otherwise without reasonable basis." *Katz v. Household Int'l., Inc.*, 91 F.3d 1036, 1039 (7th Cir.1996). "Projections which turn out to be inaccurate are not fraudulent simply because subsequent events reveal that a different projection would have been more reasonable." *In re HealthCare Compare*, 75 F.3d at 281. Under the PSLRA, a forward-looking statement is actionable against a person only where it "was made with actual knowledge by that person that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(i); *see also Employers Teamsters Local Nos. 175 and 505 Pension Trust Fund v. Clorox Co.*, 353 F.3d 1125, 1133 (9th Cir.2004) (actual knowledge required for forward-looking statements); *Theoharous v. Fong*, 256 F.3d 1219, 1225 (11th Cir.2001) (With respect to forward-looking

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[11] Defendants do not argue that the "total mix" of information available to investors on December 12, 2000 included cautionary language that would protect this statement. *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1122-23 (10th Cir.1997); *Stavros v. Exelon Corp.*, 266 F.Supp.2d 833, 844 (N.D.Ill.2003).

statements, "the plaintiff must prove that the defendant made the statement with 'actual knowledge' that it was 'false or misleading.'"); *Stavros v. Exelon Corp.*, 266 F.Supp.2d 833, 847 (N.D.Ill.2003) (Plaintiffs must plead facts that show "a strong inference that Defendants actually knew" their projections were false or misleading.). A forward-looking statement is actionable against a corporation such as Tellabs if it was "made by or with the approval of an executive officer of that entity," and it was "made or approved by such officer with actual knowledge by that officer that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(ii). In order to survive a motion to dismiss the December 11, 2000 forward-looking statement, "[p]laintiff must plead with particularity facts that strongly imply that Defendants actually knew that the projections were false or misleading when they made them." *Stavros*, 266 F.Supp.2d at 847.

Plaintiffs allege that Defendants knew on December 11, 2000 that the projection of 30% sales growth for 2001 was false and misleading because Tellabs was experiencing a substantial decline in demand for the TITAN 5500 at the time and was engaging in channel stuffing activities to fraudulently conceal that decline. They further contend the projection was false because the TITAN 6500 was not available, was far behind schedule, and was failing laboratory evaluations.

The December 2000 projection claim is dismissed with respect to Defendants Birck, Ryan, Jackman, and Kohler. Plaintiffs do not specifically allege that these Defendants were even aware of the December 11, 2000 earnings projection. Plaintiffs do not particularize their allegations of actual knowledge regarding these Defendants, and they fail to link the projection to these Defendants.

Plaintiffs allege that Defendants Notebaert and Pullen attended the December 11, 2000 analyst conference where the

projection was made. As discussed in detail below, Plaintiffs do not allege sufficient facts to support a strong inference that Pullen was reckless, much less that he had actual knowledge that the projection was incorrect. Accordingly, the Court dismisses Pullen with respect to this projection.

With respect to Notebaert, Plaintiffs' allegations also fail to support a strong inference of actual knowledge of falsity or baselessness. As discussed below, Plaintiffs' group pleading allegations and conclusory statements do not satisfy the PSLRA's scienter requirements for projections.

Given that Plaintiffs have failed to create a strong inference that the December 11 projection was made by any officer with actual knowledge that the statement was false or misleading, Plaintiffs' claim against Tellabs for the December 11, 2000 projection also fails.

IV. Alleged Misrepresentations

Plaintiffs allege that Defendants made a series of false and misleading statements regarding their financial performance and the success of their products. Plaintiffs alleged misrepresentations fall into the following categories: 1) statements regarding demand for the TITAN 5500; 2) statements concerning the TITAN 6500; 3) statements regarding the SALIX technology; and 4) statements regarding Tellabs' fourth quarter 2000 financials. The Court will address each of these categories.

A. Statements Regarding the TITAN 5500

Plaintiffs allege that Defendants made a series of misrepresentations regarding the status of the TITAN 5500. Plaintiffs allege that these statements were false because demand had dropped for the TITAN 5500, Defendants engaged in deceptive practices to disguise the decrease in demand, and Tellabs' internal reports confirmed the decline in demand. The Court will review each of the statements about the TITAN 5500 below.

The Court previously found that Notebaert's general, non-product specific statement that "[w]e feel very, very good about the robust growth we're experiencing" constituted mere puffery. *Tellabs*, 262 F.Supp.2d at 951. Plaintiffs have not provided any argument for the Court to reconsider this ruling. As the Seventh Circuit has noted, "[m]ere sales puffery is not actionable under Rule 10b-5." *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 746 (7th Cir.1997). *See also Gallagher v. Abbott Labs.*, 269 F.3d 806 (7th Cir.2001) (holding vague statements and statements of puffery, such as general predictions of success are not actionable).

Similarly, the statement "demand for our core optical products, or our core networking products remains strong ..." is also puffery. That general statement does not specifically refer to any one product, including the products Plaintiffs identify as the backbone of their complaint. *See In re Splash Tech. Holdings, Inc. Sec. Litig.*, 160 F.Supp.2d 1059, 1077 (N.D.Cal.2001) (Statements describing "strong" demand, "better than expected," or "robust" results, a growth strategy that "was unfolding as planned," a "well positioned" company, a "solid" company position, and an "improved" product line are nonactionable puffery; further, "statements which used the words 'healthy,' 'strong,' or 'increased awareness' constitute[ ] vague assessments of past results, on which no reasonable investor would rely."); *Next Century Communications Corp. v. Ellis*, 318 F.3d 1023, 1028 (11th Cir.2003) ("strong performance" statement was mere puffery); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 206-07 (1st Cir.1999) ("upbeat statements of optimism," "excellent performance," and "increased" sales are not actionable); *Asher v. Baxter Intern., Inc.*, No. 02 C 5608, 2003 WL 21825498, *16 (N.D.Ill. July 24, 2003) ("the overall financial dynamic for Baxter is very strong"—is mere puffery); *Kafenbaum v. GTECH Holdings Corp.*, 217 F.Supp.2d 238, 250 (D.R.I.2002) (statements that a company is "on course to restore growth in the business . . ." and that the company

"remains confident that our business is sound" are not actionable); *Simon v. Am. Power Conversion Corp.*, 945 F.Supp. 416, 428 (D.R.I.1996) (statement that "we are gaining market share, we are gaining momentum, and our revenues are strong" is puffery). Pullen's December 2000 statement also falls in this puffery category: "[t]he TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (R. 63-1, SAC ¶ 77.) Likewise, Notebaert's December 2000 statement that the company "expected continuing growth of the TITAN 5500" is also non-actionable puffery. (*Id.* ¶ 76.)

The statement "[a]lthough we introduced this product nearly 10 years ago, it's still going strong because we keep adding new capabilities so it can do more and more for our customers" is also puffery because Plaintiffs have not made any allegations that the TITAN 5500 did not grow and improve over a 10 year period. Plaintiffs' allegations are instead focused primarily on the fourth quarter of 2000.

The more troubling statements based on the allegations in the case are those specifically referring to the success of the TITAN 5500 during the Class Period. On March 8, 2001, in response to a question from a Deutsche Bank analyst as to whether Tellabs was experiencing any weakness in the TITAN 5500 sales, Notebaert responded: "[w]e're still seeing that product continue to maintain its growth rate; it's still experiencing strong acceptance." (*Id.* ¶ 102.)

As discussed in detail below, Plaintiffs allege that Defendants fraudulently misrepresented Tellabs' financial condition. They allege that Defendants engaged in channel stuffing and other deceptive practices to disguise the decrease in demand for the TITAN 5500 in the fourth quarter of 2000. Given these allegations regarding the underlying financials, the Court will not dismiss these alleged statements as mere puffery.

B. Statements Regarding the TITAN 6500

During the purported Class Period, Defendants made numerous statements regarding the TITAN 6500. Plaintiffs allege that these statements regarding the TITAN 6500 were false and misleading because there was a lack of demand for the product, the TITAN 6500 was significantly behind production schedule, customers did not accept the product, and the TITAN 6500 failed customer and laboratory trials. Plaintiffs support their allegations with information from numerous confidential sources who worked at Tellabs.

The Court previously found that Notebaert's statement, "on the 6500, demand for that product is exceeding our expectations . . . ." is puffery. (*Id.* ¶ 84.) *See In re Allaire Corp. Securities Litig.*, 224 F.Supp.2d 319, 331 (D.Mass.2002) (statement that product "exceeded our expectations since it became generally available in December" is "clear puffery"). "It is hard to imagine a more subjective or vague statement than 'exceeded our expectations.'" *Id.* The Court's prior ruling stands. Furthermore, the statement "[w]e are as confident as ever—that may be an understatement—about the 6500" is also puffery.

Plaintiffs allege that a series of statements regarding a contract with Sprint for the TITAN 6500 are false and misleading. On December 11, 2000, Defendants issued a press release announcing a multi-year sales agreement with Sprint for the TITAN 6500. The press release announced that the "agreement is expected to be valued at more than $100 million over the life of the contract." (R. 63-1, SAC ¶ 73.) In January 2001, Notebaert stated that the Sprint deal was Tellabs' "first customer success with this new product."

Plaintiffs allege that this press release is misleading because Sprint's purchase of the TITAN 6500 "was merely to satisfy a pre-existing purchase obligation that arose when Sprint canceled another product purchase, and would not

result in continued sales." (*Id.* ¶ 74e.) This alleged motivation behind the contract, however, does not make the press release announcing the contract false.

Plaintiffs further allege that the December 11 press release is false because the TITAN 6500 was not available at the time and its production was "far behind schedule." (*Id.* ¶ 74.) The press release specifically noted: "[t]he TITAN 6500 system is available now." (*Id.* ¶ 73.) Plaintiffs have particularized through various confidential sources that the TITAN 6500 was not "available" for release in December 2000. Defendants argue that customers could have purchased the TITAN 6500 through contract at the time, even though the product may not have been available for shipment. The meaning of "available now" is a factual issue that the Court cannot properly decide on this motion to dismiss. The statement is therefore actionable.

Tellabs also made numerous statements during the purported Class Period about the TITAN 6500 sales that were not linked to the Sprint contract. For example, in its 2000 Annual Report, Tellabs said that its customers "are embracing" the TITAN 6500. (*Id.* ¶ 90.) This statement is mere puffery, and is not actionable despite the allegations that certain customers were not satisfied with the TITAN 6500 and it failed their lab tests. *See Scritchfield v. Paolo*, 274 F.Supp.2d 163, 181 (D.R.I.2003) (holding that defendant's claim of attaining "critical mass" of customers was non-actionable puffery).

On March 8, 2001, Notebaert said "[i]nterest in and demand for the 6500 continues to grow. . . . We continue to ship the . . . 6500 through the first quarter." We are satisfying very strong demand and growing customer demand. (R. 63-1, SAC ¶ 100.) These statements specifically pertain to the TITAN 6500 and the demand for the product. Plaintiffs have provided particularized allegations that contradict Defendants' affirmative representations regarding the demand,

acceptance, and development of the TITAN 6500. These statements pertain to a new product and its prospects for growth. Such misrepresentations are actionable. *See In re Allaire*, 224 F.Supp.2d at 331-32 (statements that newly developed product was "fueling growth" were actionable).

On April 6, 2001, an analysts inquired whether Tellabs was still on track to recognize TITAN 6500 revenue in the second quarter. Notebaert responded "we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." (R. 63-1, SAC ¶ 117.) This statement is actionable for the reasons discussed above.

In a June 5, 2001 press release, Pullen announced that Tellabs was "enhancing [its] broadband networking systems to help service providers capitalize on the global business opportunities of today and tomorrow." He added that "[o]ur TITAN 6500 system is the industry's only carrier-class transport system that uses the most innovative cell-based switching fabric with electrical and optical capabilities for converged services." Plaintiffs fail to particularize how this statement about the product's characteristics is misleading. This statement is not actionable.

C. Statements Regarding the SALIX Technology

Plaintiffs have identified several statements regarding Tellabs' SALIX technology that they allege are actionable. Plaintiffs allege that Defendants falsely portrayed the SALIX technology as "leading edge" and successful during the purported Class Period. Plaintiffs allege that such statements were false and misleading because the "SALIX technology was both unfinished and outmoded." (*Id.* ¶ 56.) Plaintiffs contend that Tellabs "did not invest more money and personnel in the product" to commercialize it, as it needed to do. (*Id.* ¶ 57.) They further allege that in late April 2001, at a

"town hall" meeting, Defendant Notebaert "conceded that the SALIX technology was not current technology, and that there were other technologies that superceded it," according to a confidential source. (*Id.* ¶ 60.)

Plaintiffs identify four statements made prior to April 18, 2001 regarding the SALIX technology that they contend are false and misleading. First, Plaintiffs point to a January 30, 2001 statement describing the SALIX technology: "The SALIX 7600 suite brings together voice and data technologies to create a set of telepacket service applications that can help carriers grow profitably." (*Id.* ¶ 88.) In the same statement, Tellabs announced that it "can now offer integrated comprehensive solutions to all carriers." (*Id.* ¶ 88.) Even Plaintiffs acknowledge that Tellabs was selling the SALIX technology. (*Id.* ¶ 57.) Plaintiffs have not identified any falsities in this statement regarding the SALIX technology.

Second, Plaintiffs identify a statement in Tellabs' 2000 Annual Report that the "new SALIX 7750 next-generation switch positions Tellabs in a new category where we see a lot of opportunities." This "opportunities" statement is mere puffery. *See In re Peritus Software Services, Inc. Sec. Litig.*, 52 F.Supp.2d 211, 220 (D.Mass.1999).

The final two statements also appeared in the 2000 Annual Report. Tellabs noted "[o]ur new SALIX next-generation switches have built an enviable track record in this fledgling market." (*Id.* ¶ 92.) This statement is not misleading, especially in light of Tellabs' press release on January 23, 2001 announcing that the SALIX product group "generate $40 million in sales in the fourth quarter of 2000, down from $66 million a year ago." (R. 74-1, Def.'s Mot. to Dismiss SAC App., Ex. 1.) The Annual Report further noted that Tellabs "successfully launched five new products in 2000," including the "SALIX 7750 next-generation." (R. 63-1, SAC ¶ 93.) This reference is again corporate puffery that is not actionable.

Further, on April 18, 2001, *during the Class Period*, Defendants disclosed the very problems that Plaintiffs allege were withheld from the class. Specifically, Tellabs issued a press release announcing that it was "terminat[ing] the SALIX next-generation-switching product effort." (*Id.* ¶ 121; R. 49-1, Def.'s Mot. to Dismiss Comp.App., Ex. 18.) This is precisely what Notebaert disclosed in the "late April 2001" town hall meeting that Plaintiffs use as an example of withholding information from the public. Plaintiff cannot claim that Tellabs' stock price was artificially inflated during the purported Class Period based on alleged misrepresentations when Tellabs actually disclosed the basis of the alleged misrepresentation to the public *during* the Class Period. Materiality exists where "there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor to have significantly altered the total mix of information." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995). Here, Tellabs disclosed the very information at issue *during* the purported Class Period. Plaintiffs have pled themselves out of court with respect to any statements made on or after April 18, 2001 pertaining to the SALIX technology.

D. Financial Results

Plaintiffs allege that Defendants falsely misrepresented Tellabs' financial results for the fourth quarter 2000 because Defendants were engaged in channel stuffing and other inappropriate activities involving the TITAN 5500[12] which inflated Tellabs' revenue figures and created a false picture of the demand for Tellabs' products.[13] As the Court previously

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[12] Plaintiffs do not allege that the TITAN 6500 or the SALIX technology contributed to the allegedly false financial statements.

[13] Although the SAC references Tellabs' first quarter 2001 financial statements, Plaintiffs do not allege anything false or misleading about these financials. Thus their veracity is not at issue in this lawsuit. Tellabs

noted, "channel stuffing" is the inducement of customers to substantially increase their purchases before they would otherwise buy products from the company in the normal course of business. *Tellabs*, 262 F.Supp.2d at 948 (citing *Greebel v. FTP Software*, 194 F.3d 185, 202 (1st Cir.1999)); *see also Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1184 (10th Cir.2003). Channel stuffing will "artificially inflate sales, which will then drop in the next quarter as the distributors no longer make orders while they deplete their excess supply." *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1298 (9th Cir.1998).

Plaintiffs allege that Tellabs' over-inventoried customers with its TITAN 5500 product, knowing that it would result in drastically reduced sales and huge customer returns of unwanted merchandise in early 2001. Plaintiffs further allege that Defendants wrote orders for products that customers did not want, improperly back-dated orders and offered unusual and extraordinary discounts and incentives to customers to entice them to purchase products during the fourth quarter of 2000.

1. Over-Inventorying

Plaintiffs rely heavily on allegations that Tellabs over-inventoried it customers in order to falsely portray growing revenues and demand, and failed to disclose these facts to investors. Plaintiffs back their contentions with allegations supported by at least 8 separate confidential sources with personal knowledge that Tellabs provided customers with products that the customers did not want. (R. 63-1, SAC ¶¶ 63, 64, 65, 66, 67, 68, 69, 72.) These sources corroborate each other and suggest that the information is reliable. Plaintiffs identify specific customers whom Tellabs allegedly

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experienced a 21% increase in year to year growth in the first quarter of 2001.

over-inventoried, namely Telcobuy and Verizon[14]. They even allege that Verizon's Chairman called Tellabs to complain about the channel stuffing. They also identify the specific time periods of the over-inventorying—the fourth quarter of 2000.

Plaintiffs further allege that the channel stuffing of the TITAN 5500 was of an "extraordinary" magnitude. Plaintiffs allege that Notebaert worked directly with Tellabs' sales personnel to effectuate the channel stuffing. In addition, Plaintiffs allege that Tellabs engaged in these channel stuffing activities when they did not even have an agreement with the ultimate purchaser of the product. They further contend that although customers did not need the products, Tellabs shipped them anyway.

The SAC cures the defects in the Amended Complaint regarding the over-inventoried allegations by particularizing the allegations and naming supporting confidential sources. It alleges more than general conclusions.

2. Fictitious Sales

Plaintiffs allege that Tellabs engaged in recording fictitious sales of products. In support, Plaintiffs allege that CS-3, a high-level Tellabs sales executive, reported that Tellabs employees actually wrote purchase orders for customers for products that the customers had not ordered. This bare-bones allegation without any particularized facts the who, what, when or where does not meet the mandates of the PSLRA.

3. Back Dating Orders

Plaintiffs further allege that Defendants disguised the decline in demand for Tellabs' products by backdating sales.

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[14] Although Plaintiffs identify a third customer—Lexcom—they do not particularize any details about the alleged channel stuffing other than to say that Lexcom was "victimized by Tellabs' channel stuffing." (R. 63-1, SAC ¶ 71.)

In support, Plaintiffs allege that CS-1 stated that Defendants backdated sales, including pulling sales to larger customer such as SBC and Sprint from the first quarter 2001 into the fourth quarter of 2000 to make the numbers. Plaintiffs have particularized this allegation with support from a confidential source as well as examples.

4. Customer Incentives

Plaintiffs allege that Tellabs provided customers with sales incentives which were concealed from the investing public. They further contend that these incentives were excessive, unusual, and out of line with ordinary business practices.

In support of these allegations, Plaintiffs allege that CS-1, a former Tellabs marketing manager, reported that Tellabs got "creative" to make the numbers at the end of the fourth quarter of 2000 by offering customers discounts of as much as 10% to 20% and "other incentives" (*Id.* ¶ 69.) Additionally, CS-3 represented that Tellabs offered Telcobuy very generous credit terms (90 days), rather than the normal 30 days. Plaintiffs also allege that Tellabs gave "Telcobuy additional discount incentives to buy TITAN 5500 plugs in late 1999 through late 2000."

As previously noted by the Court, customer incentives are a frequent tool of conducting business and are not inherently improper. *Tellabs*, 262 F.Supp.2d at 950. Plaintiffs' allegations do not suggest that these incentives were improper. A 60-day extension of credit terms is not extraordinary in today's business world. Furthermore, Plaintiffs do not particularize the alleged "additional discount incentives."

Although Plaintiffs contend that these undisclosed incentives contradicted Defendants' public statements, they fail to identify any specific public statements that they contradict. Providing sales discounts and incentives, without more, certainly does not contradict statements of growth.

5. Allegations Taken as A Whole

It is clear that there may be "legitimate reasons for attempting to achieve sales earlier" by engaging in channel stuffing. *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir.2003). Plaintiffs, however, have alleged that Defendants engaged in channel stuffing in order to falsely misrepresent their financial condition. Although several categories of Plaintiffs' allegations fail regarding channel stuffing, when viewing the totality of the SAC's allegations, Plaintiffs have sufficiently particularized their allegations that Defendants engaged in channel stuffing in order to falsely portray Tellabs' financials.

V. Scienter

A. Legal Standard for Scienter

The PSLRA requires that a plaintiff "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2). Plaintiffs' Amended Complaint failed to allege scienter sufficient to meet the mandates of the PSLRA. Essentially, Plaintiffs had lumped their scienter allegations together as to all "Defendants." As the Court held in its *May 19, 2003 Opinion*, Plaintiffs must allege facts establishing that each Individual Defendant knew, or recklessly[15] ignored, that the statements were materially false or misleading. *Tellabs*, 262 F.Supp.2d at 954. This Court has rejected the Second Circuit's test for scienter where a plaintiff is required to allege either: (1) facts showing that the defendants had both motive and opportunity to commit fraud or (2) facts constituting strong circumstantial evidence of conscious

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[15] "Reckless conduct is, at least, conduct which is highly unreasonable and which represents an extreme departure from standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rehm v. Eagle Fin. Corp.*, 954 F.Supp. 1246, 1255 (N.D.Ill.1997).

misbehavior or recklessness. *Id.* Instead, Plaintiffs may use "motive and opportunity" or "circumstantial evidence" to establish scienter under the PSLRA, only if Plaintiffs' allegations support a strong inference that each Defendant acted recklessly or knowingly. *Tellabs*, 262 F.Supp.2d at 954; *see also Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 345 (4th Cir.2003) ("[C]ourts should not restrict their scienter inquiry by focusing on specific categories of facts, such as those relating to motive and opportunity, but instead should examine all of the allegations in each case to determine whether they collectively establish a strong inference of scienter.").

B. Analysis

Defendants argue that Plaintiffs have failed to allege scienter under the mandates of the PSLRA. Plaintiffs claim that they have sufficiently alleged a strong inference that each of the Individual Defendants knew or recklessly disregarded the truth.

Plaintiffs again lump many of their scienter allegations together with broad statements regarding "Defendants" or the "Individual Defendants." They allege, for example, that "Defendants also knew or recklessly disregarded that the misleading statements and omissions . . . would adversely affect the integrity of the market for the Company's common stock." (R. 63-1, SAC ¶ 148.) They further allege that "Defendants had a power motive to inflate the price of Tellabs' stock." (*Id.* ¶ 150.) Further, they contend that the "Individual Defendants were senior executive officers and directors of Tellabs and were intimately involved with and had direct responsibility with respect to important issues affecting the Company's business, operations, products, performance, and prospects." (*Id.* ¶ 152.) In its Opinion, the Court clearly noted that "[g]roup pleading allegations are insufficient under the PSLRA to establish scienter on the part of each individual Defendant." *Tellabs*, 262 F.Supp.2d at

955. Thus, these allegations alone are insufficient to establish scienter under the PSLRA.

C. Scienter Based on Insider Trading

Plaintiffs again try to support their scienter allegations with contentions regarding the sale of Tellabs' stock by insiders. Specifically, Plaintiffs allege that two of the Defendants—Birck and Kohler—sold stock during the Class Period. They also allege that four other Tellabs' "insiders" sold stock during this time.

As the Court previously held, mere allegations of insider trading during the purported Class Period alone do not support a strong inference of scienter. *Tellabs*, 262 F.Supp.2d at 954. "Unusual" or "suspicious" stock sales by corporate insiders, however, may provide circumstantial evidence of scienter. *Id.; Broudo*, 339 F.3d at 940 ("[U]nusual stock or suspicious stock sales can serve as circumstantial inference of scienter."). In order to rise to the level of "unusual" or "suspicious," the insider trading must be "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *In re Silicon Graphics, Inc.*, 183 F.3d at 986 (internal quotation omitted).

Plaintiffs fail to allege sufficient facts demonstrating that the sales by Defendants Birck and Kohler were unusual or suspicious. They do not allege the amount or percentage of overall shares sold by either of these Defendants. Indeed, at the time Defendant Birck sold 80,000 shares of common stock, he was the beneficial owner of over 37 *million* shares of Tellabs' common stock. (R. 74-1, Def.'s Mot. to Dismiss SAC App., Ex. 9). Birck's sales during the Class Period thus amount to less than 1% of his holdings. Plaintiffs do not allege the amount of profit Defendant Birck made on his sales. They also do not allege the history of trading on the part of these Individual Defendants.

Furthermore, the SAC focuses on Defendant Notebaert's allegedly fraudulent statements. Plaintiffs do not allege that CEO Notebaert sold stock during the Class Period. The absence of such allegations against him further weakens Plaintiffs' argument that the insider sales support a strong inference of scienter on the part of Notebaert. *See Druskin v. Answerthink, Inc.*, No. 02-23304, 299 F.Supp.2d 1307, 1336, 2004 WL 95402 at *22 (S.D.Fla. Jan.5, 2004).

Plaintiffs allegations of insider trading by other Tellabs' insiders who are not named as Individual Defendants also fail to support a strong inference of scienter. Plaintiffs assert that these sales "evidence senior management's knowledge of serious undisclosed problems." (R. 78-1, Pl.'s Opp. to Defs.' Motion to Dismiss SAC, p. 32 n. 26.) Plaintiffs fail to make any allegations connecting Catherine Kozik, Thomas Gruenwald, William Souders, or Peter Gugliemi to the fraudulent scheme. It would be a stretch, at best, to conclude based on the allegations in the SAC that the Individual Defendants engaged in the alleged scheme in order to financially benefit other insiders who were not part of that scheme. Thus, their sales do not bear on the issue of scienter.

D. Hands On Allegations

Plaintiffs also make numerous general statements regarding the "hands on" management at Tellabs in an attempt to establish scienter. They allege that "Tellabs' executives and directors were 'hands on' and knew everything, including the product development cycles, everyday happenings of the Company, and customer expectations." (R. 63-1, SAC ¶¶ 153-57.) Such general "hands on" allegations, however, are insufficient to establish scienter. *See In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1088 (9th Cir.2002).

E. Access to Reports

Plaintiffs also contend that a strong inference of scienter is established through the Individual Defendant's access to

reports. Tellabs' finance department generated internal quarterly status reports that were available on the company's database system regarding the profitability of Tellabs' products. These reports, according to a confidential source, "showed a decline in customer demand for the TITAN 5500 by March 2001." (R. 63-1, SAC ¶ 153e.) Plaintiffs also allege that the reports "showed declining demand in the third and fourth quarters of 2000 for a variety of Tellabs' products, including the TITAN 5500." (*Id.* ¶ 40.) Tellabs also generated daily reports concerning Tellabs' daily product bookings and revenues. Additionally, Tellabs generated weekly and monthly reports concerning various issues, including the status of product development. (*Id.* ¶ 153f.)

These general allegations alone—that Defendants received daily, weekly, and monthly reports—are insufficient to create a strong inference of scienter. *See Silicon Graphics*, 183 F.3d at 985. Mere access to internal data does not meet the dictates of the PSLRA. *See Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1035-6 (9th Cir.2002); *In re Apple Computer, Inc., Sec. Litig.*, 243 F.Supp.2d 1012, 1025 (N.D.Ca.2002); *Collmer v. United States Liquids, Inc.*, 268 F.Supp.2d 718, 753 (S.D.Tex.2003) (Mere access to reports was insufficient to plead scienter "without some additional facts such as exposure to content-identified internal corporate documents (and who drafted them, who received them or how plaintiffs learned of them) or specific conversations or attendance at specified management or board meetings dealing with such problems."); *see also Arazie v. Mullane*, 2 F.3d 1456 (7th Cir.1993) (finding internal documents insufficient to support fraud where the complaint did not indicate who prepared them, when they were prepared or what was precisely in them). Plaintiffs do not describe the contents of these reports or detail what such reports reflected. They do not allege who, other than the "finance department," prepared such reports. They do not allege any particularized facts showing how the information contained in the reports demonstrated the falsity

of Tellabs' fourth quarter financial results or sufficient facts regarding how the information supports any inference of knowledge of falsity.

With respect to the quarterly status reports, Plaintiffs contend that they showed a declining demand in the third and fourth quarters of 2000 "for a variety of Tellabs' products, including the TITAN 5500." (R. 63-1, SAC ¶ 40.) Plaintiffs, however, fail to allege what reports showed a decline in the demand and who received such reports. They also do not particularize what information was reflected in this report, how significant the decline in demand was, or how much of the decline was attributed to the TITAN 5500 as opposed to other products. The source of this information is also unclear. Although Plaintiffs allege that CS-23 "viewed" the quarterly reports, it is unclear that CS-23 provided this information. Moreover, CS-23 is a former Tellabs' engineer, thus it is unclear when or how he had access to the reports.

Additionally, Plaintiffs allege that a confidential source "revealed that these [quarterly] reports showed a decline in customer demand for the TITAN 5500 by March 2001." (*Id.* ¶ 153d.) This information in March of 2001, however, does not have any effect on the allegedly fraudulent fourth quarter 2000 financials and Plaintiffs do not allege that Tellabs' first quarter 2001 financials were fraudulent. Plaintiffs must include detailed information when basing their scienter allegations on a defendant's access to internal company reports. "The reason for requiring such detail [is] that every sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts, and that allowing a plaintiff to go forward with a case based on general allegations of 'negative internal reports' would expose all those companies to securities litigation whenever their stock prices dropped." *In re Vantive Corp. Sec. Litig.*, 283 F.3d at 1087-88 (citations and quotations omitted).

F. Probe Research Study

Plaintiffs allege that Probe Research, an independent research firm, performed a study for Tellabs. The study, according to CS-16, who worked as Tellabs' marketing strategy executive during the purported Class Period, "showed a steep drop in the number of T1 circuits required in the market." (R. 63-1, SAC ¶ 39.) According to CS-16, "T1' s were the main source of demand for Tellabs' TITAN 5500 systems." (*Id.*) Tellabs' marketing strategy department prepared an internal report in or about early 2001 concluding that "as a result of the decline in T1's, Tellabs' revenue from the TITAN 5500 would decline by approximately $400 million." (*Id.*)

This research was not completed until around early 2001—after Tellabs made its December 11, 2000 revenue projections. Significantly, the SAC does not detail when in 2001 Probe Research completed the study. It also does not state when the marketing strategy department completed and disseminated its report. Moreover, the report does not disclose when Tellabs' revenue would feel the effect of the drop in the T1 circuits and decline. Given the lack of these significant details, the Probe Research study allegations alone cannot support a strong inference of actual knowledge or recklessness.

G. Alleged Omission in Company's 2001 Annual Report

Plaintiffs claim that certain "admissions" by Tellabs support a showing of scienter. Specifically, in its 2001 Annual Report, dated January 22, 2002, Tellabs noted:

> Early in 2001, as our customers reduced capital spending and expressed caution about the future, Tellabs began a deep process of self-examination. We faced difficult decisions, the most onerous being our need to match capacity and expenses with demand to preserve profitability.

> Making a company smaller is painful. In April 2001 we began a series of layoffs, a process that continues through March 2002, reducing our worldwide workforce by about 27% to around 6,700 people. We closed manufacturing plants in Ireland and Texas, consolidated product development and other functions from 30 facilities into 20, and cut expenses dramatically.

(*Id.* ¶ 141.)

These post-class statements are completely consistent with statements made during the purported Class Period. On April 18, 2001, as alleged in Plaintiff's SAC, Tellabs issued a press release noting: "[i]n light of reduced and deferred spending by major communications carriers, Tellabs will realign its cost structure with its current expectations for lower revenue growth." (*Id.* ¶ 121.) The press release further noted that Tellabs would be "reducing its workforce by about 550 people . . . [that it had] eliminated 450 temporary or contract positions . . . and will not fill 1,100 open positions." (R. 85-1, Def.'s Reply Mem., Ex. D.) The Annual Report statements do not contradict the company's statements in April 2001. Therefore, the statements in the Annual Report do not support even a weak inference of scienter. *See e.g., In re Read-Rite Corp.*, 335 F.3d 843, 846 (9th Cir.2003).

H. Individual Defendants

The Court will now analyze whether Plaintiffs have alleged sufficient facts to establish that each Individual Defendant knew, or recklessly ignored, that the allegedly fraudulent statements were materially false or misleading. The Court will also address in this section whether each of the Individual Defendants is accountable for those statements remaining in the case. The PSLRA requires Plaintiffs to particularize the role of each Individual Defendant in the alleged misrepresentations. Plaintiffs must allege facts sufficient to support an inference that the misrepresentation was

made by or is attributable to a particular Individual Defendant or that the Individual Defendant had control over the content of the statement.

1. John Kohler

Kohler was the Senior Vice President of Global Business Operations during the Class Period. Plaintiffs do not allege that Kohler made any of the allegedly false statements at issue in this case. Instead, they use group pleading to assert that the statements are "the collective actions of the narrowly defined group of Defendants . . . by virtue of their high-level positions with the Company and 'hands on' management style." (R. 63-1, SAC ¶ 24.) They allege that "Defendants were involved in the fraudulent activities herein alleged and were also involved in drafting, producing, reviewing, and disseminating the materially false and misleading statements and information alleged herein; were aware, or recklessly disregarded, that the materially false and misleading statements were being issued regarding the Company; and approved or ratified these statements, in violations of the federal securities laws." (*Id.* ¶ 24.) Plaintiffs further assert that the "Individual Defendants, because of their positions of control and authority as officers and directors of the Company, were able to and did control the content of the various SEC filings, press releases, and other public statements pertaining to the Company during the Class Period." (*Id.* ¶ 27.) They allege that the Individual Defendants had copies of the documents and had the "ability and opportunity to prevent their issuance or cause them to be corrected." (*Id.* ¶ 27.)

Under the mandates of the PSLRA, the Court must evaluate the allegations concerning each of the Individual Defendants separately. Plaintiffs' broad, general allegations regarding Kohler's responsibility for statements made by other Defendants fall far short of sufficiently attributing the statements to him. Plaintiffs do not set forth sufficiently particularized allegations that Kohler knew about the statements

or had any control over them. They do not allege that Kohler controlled, or could have controlled, such statements. Plaintiffs further do not assert that Kohler drafted any of these statements or participated in the approval of such statements. In short, Plaintiffs have not pled specific facts connecting Defendant Kohler to any of the statements that are allegedly false and misleading. Thus, they cannot provide a basis for federal securities fraud liability against Kohler. Accordingly, Kohler is dismissed from Count I.

2. Robert Pullen

During the Class Period, Robert Pullen was Tellabs' Senior Vice President and General Manager of Optical networking. Plaintiffs have identified two allegedly false statements made by Pullen in their SAC. The first statement is one attributed to Pullen by ABN AMRO, Inc., following a December 11, 2000 conference with securities analysts. Pullen allegedly commented that the "TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." But Plaintiffs do not particularize any scienter allegations against Pullen pertaining to the TITAN 5500. Plaintiffs only allege that Pullen had knowledge regarding the TITAN 6500. Additionally, as discussed above, the Court dismissed this statement as puffery. Accordingly, Plaintiffs have not met their scienter burden regarding this statement attributed to Pullen.

The second statement in the SAC attributed to Pullen is one made on June 5, 2001 regarding the TITAN 6500. As the Court noted above, however, this statement is mere puffery and thus not actionable.

With respect to those statements not made by Pullen, as with Kohler, Plaintiffs have failed to plead specific facts connecting Pullen to them. They use the same group pleading allegations noted above in an attempt to impose liability on Pullen for such statements. But these group

pleading allegations do not meet the mandate of the PSLRA. Plaintiffs have not particularized why or how Pullen should share responsibility for these statements. Accordingly, Count I is dismissed with respect to Defendant Pullen.

3. Joan Ryan

Ryan was Tellabs' Executive Vice President and Chief Financial Officer during the Class Period. Plaintiffs' allegations regarding Ryan's scienter are sparse. Plaintiffs allege that Ryan made quarterly presentations with respect to Tellabs' financial position at the "town hall" meetings. Given her financial position at the company, this duty is not surprising. Plaintiffs do not allege that Ryan did anything fraudulent or questionable at these meetings. They further do not allege that Ryan knew of the alleged problems with the products at issue.

Plaintiffs main allegation against Ryan is that she knew about the channel stuffing. As the Ninth Circuit recently noted, however, "channel stuffing claims may have some probative value insofar as the channel stuffing was done so as to artificially inflate income, but there may also be other legitimate reasons for attempting to achieve sales earlier." *Broudo*, 339 F.3d at 940. Furthermore, Plaintiffs have failed to plead particular facts supporting this general conclusion with respect to Ryan. They do not allege specific channel stuffing activities, when they took place, what customers these activities affected, or when she knew about them. These allegations do not factually link Ryan to any allegedly fraudulent statements. Although allegations regarding channel stuffing may be sufficient to allege a misrepresentation, Plaintiffs' conclusory allegations regarding Defendant Ryan's knowledge of channel stuffing, without more, cannot support a strong inference that she knew or recklessly ignored that the statements were materially false or misleading. *See Greebel*, 194 F.3d at 185 (concluding that channel stuffing allegations "[do] not support a strong inference of scienter"); *In re Splash*

*Tech. Holdings Sec. Litig.*, 160 F.Supp.2d 1059, 1075-76 (N.D.Cal.2001); *Pirraglia v. Novell Inc.*, No. 2:99CV995C, 2000 WL 33194748, at *2-3 (D.Utah Nov.2, 2000) (finding that "channel stuffing" does not support a "strong inference" of scienter); *Fitzer v. Security Dynamics Tech., Inc.*, 119 F.Supp.2d 12, 36 (D.Mass.2000) (same); *In re Dura Pharm., Inc. Sec. Litig.*, No. 99CV0151-l(NLLS), 2000 WL 33176043, at *8 (S.D.Cal. July 11, 2000) (finding no strong inference of scienter from alleged "channel stuffing"); *In re Trex Co., Inc. Sec. Litig.*, 212 F.Supp.2d 596, 608 (W.D.Va.2002) ("Allegations of channel stuffing, standing alone, are insufficient to sustain the state of mind requirement in a securities fraud claim because 'there may be a number of legitimate reasons for attempting to achieve sales earlier' than in the normal course").

Plaintiffs suggest that they have alleged scienter because Ryan signed the company's SEC filings and financial statements. While Ryan is certainly accountable for the financial statements and SEC forms that she signed, that accountability alone does not automatically arise to the requisite level of scienter. *See In re Sunterra Corp. Sec. Litig.*, 199 F.Supp.2d 1308, 1330 (M.D.Fla.2002) (signatures on SEC Forms alone do not raise a strong inference of scienter). Plaintiffs must still meet the mandates of the PSLRA and properly allege a strong inference of scienter. They must provide particularized factual allegations that support a strong inference that Ryan knew or recklessly disregarded that the allegedly fraudulent statements and SEC forms were false or misleading when made. Plaintiffs have failed to do so with respect to Defendant Ryan.

In viewing the totality of the allegations against Ryan, Plaintiffs fall short of meeting their burden regarding scienter. Accordingly, Count I is dismissed with respect to Ryan.

4. Michael Birck

During the Class Period, Birck served as Chairman of the Board. Plaintiffs allege that Birck had his "hands on the pulse of everything" at Tellabs. (R. 63-1, SAC ¶ 154.) They contend that Birck communicated with employees at town hall meetings and heard sales personnel briefings concerning product status and other matters. They allege that he "knew the status of each product, how it was working, if the product was selling, and to whom from speaking with sales people . . . ." (*Id.* ¶ 154.) Plaintiffs also allege, according to a confidential source, that Harvey Scull, the head of Tellabs' mergers and acquisition group had conversations with Defendant Birck. Although Plaintiffs allege that Scull received information regarding market data and research and acquisition targets, they do not allege what information Scull provided to Birck, when he provided it, or the relevance of such information. Birck also signed the SEC Forms.

In essence, Plaintiffs' scienter allegations amount to the argument that Birck knew or recklessly disregarded the falsity of the statements because of his position with the Company, and that he sold less than 1% of his Tellabs' common stock holdings during the Class Period as discussed above. Given the mandates of the PSLRA, these allegations in their totality fall short of providing a strong inference of scienter. *See Advanta*, 180 F.3d 525, 539 (3rd Cir.1999) ("Generalized imputations of knowledge do not suffice, regardless of the defendants' positions within the company."). Birck is dismissed from Count I.

5. Brian Jackman

Jackman was President of Global Systems and Technology and Executive Vice President, as well as a Director, during the Class Period. Jackman had the responsibility for all product divisions worldwide.

Plaintiffs allege that Jackman reviewed daily reports concerning Tellabs' daily product bookings and revenue on a weekly basis. (R. 63-1, SAC ¶ 153e.) They contend that Jackman ran Tellabs prior to Notebaert's appointment as Tellabs' CEO "and all information flowed up" to him. Furthermore, Plaintiffs allege that "[a]s the head of Tellabs' 'Product House,' it was Jackman's responsibility to know what the market was doing so that he could invest in the right products to meet the market." (*Id.* ¶ 157.) Jackman "ran the whole product side of Tellabs' business. Jackman reported directly to Birck." (*Id.* ¶ 158.)

As an initial matter, Plaintiffs fail to allege that Jackman had any involvement with or knowledge regarding the alleged problems with the TITAN 5500. Instead, the scienter allegations regarding Jackman pertain only to the TITAN 6500. Plaintiffs have therefore not established that Jackman is liable for any of the alleged misrepresentations regarding the TITAN 5500.

According to CS-3, Jackman knew that the TITAN 6500 was not ready for development despite Tellabs' public announcements. (*Id.* ¶ 171.) Nonetheless, Tellabs introduced it in 2000 and customers realized that it "was not even close to being ready" when they put the product in their labs. (*Id.* ¶ 171.) CS-3, however, left Tellabs prior to the commencement of the purported Class Period. Plaintiffs fail to state how CS-3, who no longer works for Tellabs, has information about Jackman's knowledge during the purported Class Period. Without this information, the Court cannot distinguish whether the allegations about Jackman are "mere rumor and speculation or whether [they are] based on concrete information from . . . people who were in a position to know the truth of the allegations." *Adams v. Kinder-Morgan*, 340 F.3d at 1101. Plaintiffs have therefore not particularized their allegations with respect to Jackman.

6. Richard Notebaert

Notebaert served as Tellabs' Director and its CEO and President during the Class Period. Plaintiffs allege that Notebaert made many of the false and misleading statements complained of in this action. Plaintiffs have alleged that Notebaert knew or recklessly ignored that they were false and misleading because, as CEO, he was informed of the serious problems affecting Tellabs' business, products, and performance. They allege, as with some of the other executives, that Notebaert attended town hall meetings of Tellabs' employees, "had telephone calls every day and stayed on top of everything," had discussions with Senior Vice Presidents regarding weekly revenue calls and had his "hands on the pulse of everything." (R. 63-1, SAC ¶ 153.) They further allege that Notebaert knew the status of Tellabs' products, including whether or not they were selling. (*Id.* ¶ 154.) These allegations support that Notebaert was active in Tellabs' business as one would expect, but they do not establish scienter. *See Zishka v. American Pad & Paper Co.*, 72 Fed.Appx. 130, 131 (5th Cir.2003) (finding defendants' positions within the company insufficient to presume knowledge of the company's alleged false statements). Plaintiffs do not disclose any details regarding what Notebaert allegedly learned during these calls or meetings that support an inference of scienter.

Furthermore, the allegation that Notebaert attended a late April 2001 meeting where he explained that the SALIX technology was not current and was superseded by other technologies is consistent with Tellabs' April 18, 2001 public disclosure announcing termination of its SALIX product line. Given that Tellabs had disclosed this information *before* late April, this allegation does not even support an inference of negligence, much less recklessness.

Plaintiffs also allege that Notebaert attended a meeting in February 2001 with approximately 24 SALIX and Tellabs

employees regarding the SALIX product line. (R. 63-1, SAC ¶ 153.) Plaintiffs fail, however, to identify any details about the meeting or the information conveyed to Notebaert.

Plaintiffs also generally allege that "Notebaert knew the status of each product, how it was working, if the product was selling, and to whom from speaking with sales people." (*Id.* ¶ 154.) This general conclusion does not satisfy the scienter requirements under the PSLRA.

The SAC also includes allegations regarding Notebaert and channel stuffing. Plaintiffs allege that Notebaert worked directly with Tellabs' sales personnel to effect channel stuffing with respect to Tellabs' customer, SBC. Plaintiffs further allege that, according to CS-3, Notebaert knew about the channel stuffing activity relating to the TITAN 5500 and he "pushed and prodded the Company's sales personnel." (*Id.* ¶ 156.) These conclusory statements, however, are not supported with any details. Plaintiffs do not provide details of any specific actions taken by Notebaert to further the channel stuffing. They do not identify what channel stuffing activities he worked on. Such allegations are critical because the Court has concluded that there is nothing inherently wrong with several of Plaintiffs' channel stuffing allegations. It is also significant that CS-3 left Tellabs *prior* to the commencement of the purported Class Period. Without more specific allegations, and without a more reliable source, Plaintiffs have not sufficiently pled a strong inference that Notebaert knew of any actionable channel stuffing activities.

Plaintiffs conclusory allegations regarding Notebaert do not create a strong inference that he acted with the requisite state of mind under the PSLRA. Plaintiffs rely on group pleading allegations about Notebaert's position in the company and general conclusions concerning his knowledge of the allegedly fraudulent activities without providing particulars to reinforce their general conclusions. Such allegations fail to meet the mandates of the PSLRA.

VI. Section 20(a)—Control Person Liability

This Court previously dismissed Plaintiffs' Section 20(a) claim for failure to allege specific control as to Defendants Gruenwald, Kohler, Puller, and Souders, and for failure to allege an underlying securities violation. Defendants seek to dismiss Plaintiffs' claim for control person liability under Count II of the SAC on the same grounds.

A. Rule 9(b) Applies to Section 20(a) Claims

Initially, Plaintiffs suggest that this Court wrongly concluded that the heightened pleading requirements of Rule 9(b) apply to Section 20(a) control person allegations. (R. 78-1, Pls. Opp. to Mot. to Dismiss p. 37 n. 28.) Plaintiffs have cited several cases holding that Rule 9(b) does not apply to Section 20(a), but those opinions are not binding on this Court, and this Court is not persuaded by their reasoning. Section 20(a) claims are sounded in fraud, thus Plaintiffs must meet the heightened pleading requirements of Rule 9(b). *See In re Loewen Group Inc.*, No. Civ.A 98-6740, 2003 WL 22436233, *7 (E.D.Pa. July 16, 2003) ("Section 20(a) claims sound in fraud and therefore must comply with the pleading requirements of Federal Rule of Civil Procedure 9(b)"); *Wafra Leasing Corp. 1999-A-1 v. Prime Capital Corp.*, 204 F.Supp.2d 1120, 1126 (N.D.Ill.2002) (same); *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC*, No. 02 Civ. 0767 LBS, 2002 WL 31819207 at *9 (S.D.N.Y. Oct.10, 2002) (same).

B. Control Person Liability

Defendants again seek to dismiss the control person claim on the ground that Plaintiffs have failed to allege a primary securities fraud violation. In order to state a Section 20(a) claim, Plaintiff must allege the following: (1) a primary securities violation; (2) each of the Individual Defendants exercised general control over the operations of Tellabs; and (3) each of the Individual Defendants "possessed the power

or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir.1992). Because Plaintiffs have failed to plead a primary securities violation, Count II is dismissed.

Furthermore, Plaintiffs have failed to allege that Defendants Kohler or Pullen exercised the requisite level of control over either the Company or possessed the power or ability to control the alleged misrepresentations and projections.

1. Kohler

Plaintiffs have failed to allege sufficient facts to support the conclusion that Defendant Kohler was a control person. Plaintiffs allege that Kohler served as Tellabs' Senior Vice President of Global Business Operations (Global Manufacturing) from February 2000 to March 10, 2003, and as Tellabs' Vice President of Global Manufacturing from 1992 through 2000. (R. 63-1, SAC ¶ 19.) "Kohler was a sales-oriented person." (*Id.* ¶ 158.) Plaintiffs allege that as part of his sales position, Kohler attended meetings with senior level employees of certain Tellabs' customers. (*Id.* ¶ 159.) These allegations fail to support the assertion that Kohler had control over Tellabs or the power or ability to control the alleged misrepresentations at issue in this case. Plaintiffs do not allege that Kohler made any of the statements at issue. Nor do they specifically allege that he was aware of any such statements being made. Kohler did not sign any of the SEC filings at issue. His position as a corporate officer who reports to others, without more, is insufficient to allege Section 20(a) liability. *See generally Starr v. AHey, Inc.*, 2003 WL 21212596, *4 (N.D.Ill. May 23, 2003) ("[A] plaintiff may not premise control person liability solely upon status within the company.").

2. Pullen

With respect to Pullen, Plaintiffs allege that he served as Tellabs' Senior Vice President and General Manager of Optical Networking from August 2000 to February 2, 2002. (R. 63-1, SAC ¶ 21.) In that capacity, Plaintiffs allege that Pullen "had responsibility with respect to the TITAN series products at issue in this action." (*Id.*) They allege that Pullen was aware of TITAN 6500 production problems and that the product was failing evaluations. (*Id.* ¶ 50.) Plaintiffs further allege that Pullen made numerous visits to TITAN 6500 customers in connection with failed evaluation problems. (*Id.* ¶ 50.) They allege that Pullen knew that the TITAN 6500 was not ready for disbursement despite public statements to the contrary. (*Id.* ¶ 53.)

Plaintiffs allege that at the December 11, 2000 securities analysts conference, "ABN AMRO, Inc. reported Defendant Pullen's comment that the TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (*Id.* ¶ 77d.) They do not make any other specific allegations regarding Pullen and the TITAN 5500. The only other statement attributed to Pullen is one on June 5, 2001, in a press release, where Pullen noted "[o]ur TITAN 6500 system is the industry's only carrier-class transport system that uses the most innovative cell-based switching fabric with electrical and optical capabilities for converged services." (*Id.* ¶ 129.) Plaintiffs also allege that Pullen was aware of the TITAN 6500 production problems and that the product was failing evaluations, and that he made numerous visits to TITAN 6500 customers regarding such failed evaluation problems. (*Id.* ¶ 159.)

As with Kohler, Plaintiffs fail to specifically allege that Pullen signed any of the financial reports or SEC filings at issue. They fail to specifically allege facts supporting that Kohler had the ability to control the specific activities at

issue. Accordingly, Kohler is dismissed with prejudice from Count II.

VII. Insider Trading

Plaintiffs have sued Defendants Birck (Counts III, IV, and V) and Kohler (Count III) for insider trading pursuant to Section 20A of the Exchange Act. A private cause of action exists under Section 20A against persons who purchase or sell a security "while in possession of material, nonpublic information." Such an action may be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class." *United States v. O'Hagan*, 521 U.S. 642, 666, 117 S.Ct. 2199, 2214, 138 L.Ed.2d 724 (1997) (quoting 15 U.S.C. § 78t-1(a)); *see also Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332, 1337 (7th Cir.1997). Liability under Section 20A is predicated upon an independent violation of "this chapter or of any rules or regulations[s] thereunder." 15 U.S.C. § 78t-1(a). Section 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act." *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 541 (3d Cir.1999); *see also In re Foundry Networks, Inc. Sec. Litig.*, No. C 00-4823 MMC, 2003 WL 22077729, at *16 (N.D.Cal. Aug.29, 2003). In order to assert a claim for insider trading in violation of Section 20A, a plaintiff must show a predicate violation of the securities laws. Because Plaintiffs have failed to allege a securities fraud violation, Counts III, IV, and V are dismissed.

CONCLUSION

Defendants' motion to dismiss is granted. Plaintiffs have had three chances to plead their case against Tellabs and the Individual Defendants. In its *May 19, 2003 Opinion*, the Court provided Plaintiffs with a detailed analysis of the deficiencies in their complaint. The Court also granted Plain-

tiffs' request for an extension to file their SAC in order to give them more time to conduct their investigation into the allegations at issue. Plaintiffs, however, still have failed to cure these deficiencies, even though they have had more than sufficient time and guidance to do so.

Rule 15(a) provides that a court should freely grant a party leave to amend pleadings "when justice so requires." Fed.R.Civ.P. 15(a). A court, however, need not provide plaintiffs with that opportunity if it finds undue delay, bad faith or dilatory motive, repeated failure to cure deficiencies by amendments previously allowed, undue prejudice to the opposing party by virtue of allowance of the amendment, or futility. *See General Elec. Capital Corp. v. Lease Resolution Corp.*, 128 F.3d 1074, 1085 (7th Cir.1997). Here, Plaintiffs have had three opportunities to plead their case. They also had fair and detailed notice of their pleading deficiencies. Accordingly, the Court dismisses the SAC with prejudice.

**APPENDIX C**

UNITED STATES DISTRICT COURT
N.D. ILLINOIS
EASTERN DIVISION

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No. 02 C 4356

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THOMAS JOHNSON,

*Plaintiff,*

v.

TELLABS, INC., MICHAEL J. BIRCK, RICHARD C. NOTEBAERT, JOHN VAUGHN, ROBERT W. PULLEN, JOAN E. RYAN, BRIAN JACKMAN, J. THOMAS GRUENWALD, JOHN C. KOLHER, WILLIAM F. SOUDERS and CATHERINE KOZIK,

*Defendants.*

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May 19, 2003

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*MEMORANDUM OPINION AND ORDER*

ST. EVE, *District Judge.*

Plaintiffs allege that Defendants engaged in a scheme to deceive and defraud the investing public as to the true value of Tellabs, Inc.'s ("Tellabs") common stock. Plaintiffs contend that Defendants carried out this scheme, in part, by making misrepresentations about Tellabs' current financial condition and future prospects. According to Plaintiffs, these misrepresentations were false and misleading and resulted in the artificial inflation of Tellabs' stock price. Plaintiffs claim that they were injured when they purchased Tellabs' common stock at these artificially inflated prices.

Defendants seek to dismiss the Consolidated Amended Class Action Complaint (the "Complaint") for failure to state a claim upon which relief can be granted pursuant to Federal

Rule of Civil Procedure 12(b)(6), for failure to plead fraud with particularity pursuant to Federal Rule of Civil Procedure 9(b), and for failure to meet the pleading standards set forth in the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b) (the "PSLRA"). For the reasons set forth below, Defendants' motion is granted.

## ALLEGATIONS

### I. The Parties

This putative class action lawsuit is brought by various plaintiffs individually and on behalf of persons who purchased common stock of Defendant Tellabs between December 11, 2000 and June 19, 2001 (the "Class Period"). On September 27, 2002, the Court appointed Makor Issues & Rights ("Makor Issues") Lead Plaintiff pursuant to 15 U.S.C. § 78(u)-4. *See Johnson v. Tellabs, Inc.*, 214 F.R.D. 225 (N.D.Ill. 2002).

Tellabs is a Delaware corporation with its principal place of business in Lisle, Illinois. (R. 40-1, Compl.¶ 21.) Tellabs designs, manufactures and markets highly specialized optical network and broadband access equipment as well as other hardware for use in fiber-optic cable networks. (*Id.* ¶ 50.) It is a global supplier of networking solutions and services that support the Internet. The Tellabs' products that are relevant to this case are the TITAN 5500, the TITAN 6500 and the SALIX 7600. All of these products are complex transmission systems utilized with optical networking systems. The TITAN 5500 is a digital cross-connect product that is utilized by many of the major telecommunications companies. (*Id.* ¶ 51.) The TITAN 6500 is a multi-service transport switch. (*Id.* ¶ 53.) The SALIX 7600 is a software control suite that helps carriers increase revenue by building low cost networks that deliver innovative new services quickly. (*Id.* ¶ 62.)

Defendants Michael Brick, J. Thomas Gruenwald, Brian Jackman, John Kohler, Catherine Kozik, Richard Notebaert,

Robert Pullen, Joan Ryan and William Souders (collectively, the "Individual Defendants") are all officers and/or directors of Tellabs. Michael Birck was a director and served as chairman of Tellabs' board of directors beginning in 2000. (R. 40-1, Compl.¶ 22.) He also served as chief executive officer and president of Tellabs from 1975 through 2000. (*Id.*) J. Thomas Gruenwald served as a senior vice president and general manager of the broadband access group since 1999 and as a vice president of strategic resources from 1995 through 1999. (*Id.*) Brian Jackman was a director of Tellabs and served as president of global systems and technology. He also was president and an executive vice president of business operations from 1990 through 1998. (*Id.*) John Kohler was a senior vice president of global business operations beginning in 2000 and a vice president of global manufacturing from 1992 through 2000. (*Id.*)

Beginning in 2000, Catherine Kozik served as chief information officer and as a senior vice president of global information services. (R. 40-1, Compl.¶ 22.) Also that year, Richard Notebaert became a director and served as chief executive officer and president of Tellabs. (*Id.*) Robert Pullen was a senior vice president and general manager of optical networking starting in 2000. Pullen also served as a vice president of engineering and marketing in the digital systems division from 1997 through 2000. (*Id.*) Joan Ryan was an executive vice president and chief financial officer since 2000. (*Id.*) Finally, William Souders served as a director of Tellabs.[1] (*Id.*)

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[1] Plaintiffs initially included John Vaughn as a defendant in the case, but subsequently voluntarily dismissed him without prejudice. (*See* R. 23-1.)

II. Stock Sales

Plaintiffs allege that Birck, Gruenwald, Kohler, Kozik and Souders[2] sold stock during the purported Class Period at an artificially inflated price.[3] During this period of time, Plaintiffs claim that Birck sold 80,000 shares for $5,183,150; Gruenwald sold 1,500 shares for $93,281; Kohler sold 7,500 shares for $484,968; Kozik sold 3,220 shares for $187,766; and Souders sold 16,000 for $560,074. (R. 40-1, Comp.¶ 22.)

III. The Telecommunications Industry

Plaintiffs allege that the telecommunications industry suffered a significant decline in demand for its products in early 2000. (*Id.* ¶¶ 3, 47.) In addition, Plaintiffs claim that the Internet sector substantially contracted, which "severely constrict[ed] continued access to capital and demand for products to maintain and further develop what had been a rapidly expanding and growing Internet and telecommunications infrastructure." (*Id.* ¶ 47.) According to Plaintiffs, many of Tellabs' competitors suffered a dramatic decline in earnings. (*Id.* ¶ 48.) Plaintiffs maintain that Defendants disguised the impact this decline had on Tellabs and, instead, falsely contended that Tellabs was not affected by the industry slow-down.

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[2] Although the Complaint alleges that Souders sold stock on February 20, 2001, Plaintiffs have acknowledge that the correct date of this sale is April 20, 2001.

[3] The Complaint also refers to trades by "Defendant Suwinski" and "Defendant Gugliemi." (R. 40-1, Compl.¶¶ 63, 79.) Neither of these people are named as defendants in the Complaint. Moreover, the Complaint does not contain any additional allegations against these individuals, including what position, if any, they held at Tellabs. Plaintiffs do not allege that Suwinski or Gugliemi made any misrepresentations or projections. Accordingly, these allegations do not state a claim against Suwinski or Gugliemi.

IV. Allegedly False Statements by Tellabs

Plaintiffs claim that during the purported Class Period, Defendants made a series of false statements and omissions that resulted in the artificial inflation of Tellabs' stock price. These purported false statements and omissions related to Tellabs' financial condition, its earnings and operations and its future prospects. Specifically, Plaintiffs maintain that Defendants falsely reported Tellabs' financial condition for fourth quarter of 2000, and provided false "guidance" for 2001. According to Plaintiffs, Defendants also communicated regularly and directly with securities analysts and provided them with these misrepresentations so that the security analysts would unknowingly falsely promote Tellabs, resulting in an artificially inflated price of Tellabs' common stock.

A. December 2000

On December 11, 2000—the start of the purported Class Period—Tellabs issued a press release announcing a strategy to deliver an all optical network. The press release noted, "Tellabs is making all-optical networking a reality . . . . We have the strategy and the products that will enable service providers to deliver and manage all-optical services on demand." (R. 40-1, Compl.¶ 52.) On that same day, Tellabs also announced a multi-year $100 million sales agreement with Sprint for the Titan 6500 multi-service transport switch. The release reported that "[t]he TITAN 6500 helps carriers manage their SONET and SDH-based broadband networks today and protects their investment as we migrate to packet networks tomorrow. The TITAN 6500 system is available now." (*Id.* ¶ 53.)

The next day, securities analysts issued positive research reports on Tellabs. UBS Warburg noted, "Tellabs maintained its guidance for 4Q 2000 and all of 2001. In doing so, the company indicated that the demand for its Titan 5500 product line remain [sic] solid in 4Q and there is visibility for at least

two years (if not more) of ongoing good growth for the product." (*Id.* ¶ 55.) It also estimated thirty-percent growth in sales for 2001. ABN AMRO reported that "the TITAN 5500 remains the workhorse of the group and is expected to see strong growth for the next 2-3 years." (*Id.*) Baird & Co. reported that Tellabs "reiterated its confidence in the telecom-spending environment" and "reconfirmed consensus growth forecasts for fourth quarter 2000 and 2001." (*Id.*)

B. January 23, 2001 Press Release

On January 23, 2001, Tellabs reported fourth quarter net income of $232 million. (R. 40-1, Compl.¶ 58.) Its press release noted that the "strength in Tellabs' core business drove record sales and earnings in the fourth quarter of 2000. Fourth-quarter 2000 sales totaled $1,018 million, up 42% from $716 million in 1999." The press release also stated that fourth quarter net income was up 41% from 1999. (*Id.*) Notebaert explained, "[t]o keep up with robust growth in communications traffic customers are buying more and more Tellabs equipment—fueling our records [sic] results and our first $1 billion quarter." (*Id.*)

During a teleconference with securities analysts that day, Notebaert commented on the TITAN 6500. Specifically, he said that "[o]n the 6500, demand for that product is exceeding our expectations . . . . We had spent . . . a large amount of time working on our ability to create or manufacture enough product to meet customer demand. Demand is just . . . huge for this product." (R. 40-1, Compl.¶ 59.) In an interview with Eric Schatzker from the Bloomberg News, Notebaert also commented: "I'm a little surprised at the performance of our stock the last few weeks, because last quarter, this quarter, we've been solid and we feel very, very good about the robust growth we're experiencing." (*Id.* ¶ 60.)

Following the press release and teleconference, numerous securities analysts issued positive research reports for Tellabs.

On January 24, 2001, for example, Morgan Stanley reiterated its "outperform" rating and noted that "sales of the TITAN products continued to fuel growth." (*Id.* ¶ 61.)

C. January 30, 2001 Press Release

Tellabs issued another press release on January 30, 2001, announcing "a new suite of softswitches, the SALIX 7600 softswitch control suite." (R. 40-1, Compl.¶ 62.) The press release noted, "[t]he SALIX 7600 brings together voice and data technologies to create a set of telepacket service applications that can help carriers grow profitably." (*Id.*) It also stated, "[w]ith the new SALIX 7600 suite, Tellabs has redefined the softswitch market and can now offer integrated, comprehensive solutions to all carriers." (*Id.*)

D. March 2001

On March 7, 2001, Tellabs issued a press release announcing that it was lowering its revenue and earnings per share expectations for the first quarter 2001. It noted, "Tellabs projects first quarter sales in the range of $830 million to $865 million . . . . The company projects earnings per share in the range of 35 cents to 38 cents, compared with prior guidance of 39 cents per share." (R. 40-1, Compl.¶ 67.) It also reported that Tellabs could not recognize revenue from TITAN 6500 shipments in the first quarter but expected to do so in the second quarter of 2001. (*Id.*) "Growth in Tellabs' core optical networking business remains strong." (*Id.*) Notebaert went on to project, "[g]iven the strong acceptance of the new TITAN 6500, we continue to target 30 percent growth in revenue and earnings for the year . . . . Demand for our new products is strong, and I am confident we have the right set of solutions to help our customers build tomorrow's converged networks." (*Id.*)

During a March 8, 2001 teleconference with securities analysts, Notebaert reiterated that "demand for our core optical products, or our core networking products remains

strong . . . . We are as confident as ever—that may be an understatement—about the 6500 . . . . To put this into a bit more perspective, we still expect revenue and EPS growth for the quarter to exceed 30% . . . . Tellabs will meet the adjusted revenue and earnings targets." (R. 40-1, Compl.¶ 68.) Notebaert also stated that Tellabs had not received "any indication from any of our major clients, major customers, of a downturn in the segment we're in . . . ." (*Id.*) Defendant Jackman added, "[t]here's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty." (*Id.*) That day, various securities analysts issued favorable reports and maintained their buy ratings for Tellabs' stock. (*Id.* ¶ 69.)

On March 29, 2001, Tellabs issued its 10-K for 2000. The "Highlights" section of the financial statement noted: "The Company achieved record levels in sales ($3,387.4), net earnings ($730.8 million) and earnings per share ($1.75)—putting it on track to meet its objective of $6 billion in annual revenues by the year 2003." (R. 40-1, Compl.¶ 71.) It also stated that "[t]he growth in optical networking product sales was a result of continued strong demand for the Company's TITAN 5500/5500S and TITAN 532L digital cross connect systems." (*Id.*) Tellabs reported that it expected "continued strong sales growth in 2001." (*Id.*)

E. April 6, 2001

On April 6, 2001, Tellabs issued another press release that lowered its first quarter guidance. The press release stated, "[t]he revised guidance stems from reduced and deferred spending by major communications carriers late in the quarter." (R. 40-1, Compl.¶ 72.)

That same day, Notebaert was quoted as saying, "[t]he good news is, orders weren't canceled, they were pushed out into the next quarter." (*Id.* ¶ 73.) In a conference call with

analysts that same day, Notebaert stated that "the 6500 is showing strength . . . we should hit our full manufacturing capacity in May or June to accommodate the demand we are seeing. Everything we can build, we are building and shipping. The demand is very strong." (*Id.* ¶ 74.)

F. April 18, 2001[4]

On April 18, 2001, Tellabs issued a press release announcing its first quarter financials for the period ending March 31, 2001 and reducing its revenue projections for 2001. Notebaert stated, "I am as confident as ever in Tellabs' long-term prospects and our ability to deliver strong revenue and earnings growth in the future." (R. 40-1, Compl.¶ 77.)

G. June 2001

On June 19, 2001, which is the close of the purported Class Period, Tellabs issued a press release revising its second quarter guidance and reducing its revenues by approximately $300 million to $500 million. (*Id.* ¶ 85.) Tellabs common stock fell from a high of $23.01 per share on June 19, 2001 to a low of $15.87 per share on June 20, 2001. (*Id.* ¶ 87.) The June 20, 2001 price reflected a "decline of more than 75% from the Class Period high of $67.125." (*Id.*)

V. Tellabs' Accounting Practices

Plaintiffs allege that Defendants knowingly and recklessly employed improper accounting practices that falsely inflated Tellabs' balance sheet and falsely reported income and expenses in the interim quarters and fiscal year during the purported Class Period, in violation of Generally Accepted Accounting Principles ("GAAP"). (R. 40-1, Compl.¶ 93.)

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[4] The Complaint also contains allegations regarding a May 9, 2001 article entitled "Tellabs on Deck" that quotes John Vaughn. That article, however, was released on May 9, *2000*—not 2001. This was published before the purported Class Period. Accordingly, it cannot support a cause of action.

They further contend that Defendants engaged in "channel stuffing" activities to conceal true sales and that Tellabs offered its customers special incentives and the unlimited right of return in order to improperly overstate Tellabs' revenues. (*Id.* ¶ 98.)

## ANALYSIS

The three count Complaint in this case is premised on securities fraud arising out of the purchase of Tellabs' common stock. In count one, Plaintiffs allege that Defendants violated Section 10(b) of the Securities and Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5. Count two alleges that the Individual Defendants violated Section 20(a) of the Exchange Act. Count three alleges that Birck, Kozik, Kohler, Souders and Gruenwald violated Section 20A of the Exchange Act by insider trading. Defendants move to dismiss the Complaint in its entirety for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6), for failure to plead fraud with particularity pursuant to Federal Rule of Civil Procedure 9(b), and for failure to meet the pleading standards set forth in the PSLRA.

### I. Legal Standard

The purpose of a motion to dismiss pursuant to Rule 12(b)(6) is to test the legal sufficiency of a complaint, not the merits of the case. *See Triad Assocs., Inc. v. Chicago Hous. Auth.*, 892 F.2d 583, 586 (7th Cir.1989). When considering a motion to dismiss, the Court considers "whether relief is possible under [any] set of facts that could be established consistent with [the] allegations." *Bartholet v. Reishauer A.G. (Zurich)*, 953 F.2d 1073, 1078 (7th Cir.1992). The Court views all the facts alleged in the Complaint, as well as any reasonable inferences drawn from those facts, in the light most favorable to Plaintiff. *See Stachon v. United Consumers Club, Inc.*, 229 F.3d 673, 675 (7th Cir.2000).

Dismissal of a complaint is appropriate only where it appears beyond doubt that under no set of facts would the plaintiff's allegations entitle him to relief. *Henderson v. Sheahan,* 196 F.3d 839, 846 (7th Cir.1999); *Kennedy v. National Juvenile Det. Ass'n,* 187 F.3d 690, 695 (7th Cir.1999). A plaintiff that solely attaches bare legal conclusions to narrated facts that fail to outline the bases of his claims does not satisfy federal pleading requirements. *Collins v. Snyder,* No. 02 C 4493, 2002 WL 31749173, at *1 (N.D.Ill.Dec.2, 2002).

II. Securities Fraud Pleading Requirements

Plaintiffs rely on two general categories of alleged misrepresentations to support their securities fraud claim: (1) Defendants' purportedly false revenue reports for the fourth quarter of 2000, and (2) Defendants' allegedly fraudulent revenue projections. Plaintiffs claim that both categories of misrepresentations artificially inflated the price of Tellabs' stock during the purported Class Period.

A. Rule 9(b) and the PSLRA

Plaintiffs' allegations are sounded in fraud. Therefore, the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) apply. Rule 9(b) mandates that a plaintiff plead "the circumstances constituting fraud . . . with particularity." *In re HealthCare Compare Corp. Sec. Litig.,* 75 F.3d 276, 281 (7th Cir.1996). As the Seventh Circuit has explained, "this means the who, what, when, where, and how: the first paragraph of any newspaper story." *DiLeo v. Ernst & Young,* 901 F.2d 624, 627 (7th Cir.1990). This particularity requirement is necessary to ensure that the plaintiff "conduct[s] a precomplaint investigation in sufficient depth to assure that the charge of fraud is responsible and supported, rather than defamatory and extortionate." *Ackerman v. Northwestern Mut. Life Ins. Co.,* 172 F.3d 467, 469 (7th Cir.1999).

In addition to Rule 9(b), the strict pleading mandates of the PSLRA apply to Plaintiffs' Complaint. In enacting the PSLRA, Congress raised the pleading standards for litigants bringing private securities fraud claims. *See In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 973 (9th Cir.1999). In order to meet the PSLRA's dictates for a securities fraud claim, "the complaint shall specify each statement alleged to have been misleading, the reasons or reasons why the statement is misleading, and if an allegation regarding the state or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1).[5]

B. Pleading on Information and Belief

Plaintiffs admit that they base many of their allegations on "information and belief." They allege that the information as to Defendants is based upon an investigation by Plaintiffs' counsel that included interviews of former Tellabs' employees and customers and a review and analysis of public filings, news articles, press releases and analysts reports by or relating to Tellabs. Defendants argue that because the allegations are based on information and belief, Plaintiffs must follow the test articulated by the Second Circuit in *Novak v. Kasaks*, 216 F.3d 300, 313-14 (2d Cir.2000). Plaintiffs contend that Defendants advocate a *per se* rule that a plaintiff must identify the names confidential sources in a complaint that is pled on information and belief.[6] A reading of *Novak*, however, shows that the Second Circuit rejected a *per se* rule. *See id.* at 314 ("we find no requirement in

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[5] The PSLRA also raised a plaintiff's pleading requirement for scienter, *see* 15 U.S.C. § 78u-4(b)(2), as the Court discusses *infra* in Section III.B.

[6] A *per se* requirement is inappropriate because it would have a chilling effect on employees who provide information about "corporate malfeasance." *In re Cabletron Sys., Inc.*, 311 F.3d 11, 30 (1st Cir.2002).

existing law that, in the ordinary course, complaints in securities fraud cases must name confidential sources").

Instead, the Second Circuit concluded that "where plaintiffs rely on confidential sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false." *Novak*, 216 F.3d at 314. The *Novak* court noted that "a complaint can meet the new pleading requirement imposed by paragraph (b)(1) by providing documentary evidence and/or a sufficient general description of the personal sources of the plaintiffs' beliefs." *Id.* This Court agrees with the Second Circuit's approach in *Novak*. Accordingly, the Court will analyze Plaintiffs' allegations consistent with *Novak* and determine the sufficiency of the facts that purport to support the allegations in the Complaint.

C. Group Pleading

Plaintiffs rely in part on group pleading and group-published documents such as Tellabs' 10-K in order to allege Defendants' misrepresentations and omissions. They allege, for example, that "[i]t is appropriate to treat the Individual Defendants as a group for pleading purposes and to presume that the materially false, misleading and incomplete information conveyed in the Company's public filings, press releases and other publications as alleged here are the collective actions of the narrowly defined group of defendants identified above." (R. 40-1, Compl.¶ 25.) They further allege that each of the Individual Defendants was an officer or director of Tellabs and, "because of their positions of control and authority as officers and/or directors of the Company, were able to and did control the content of the various SEC filings, press releases and other public statements pertaining to the Company during the Class Period." (*Id.* ¶ 28.)

The "group pleading" doctrine creates the presumption that senior executives of a corporation may be held liable for misrepresentations or omissions contained in public statements that are attributable to or issued by a corporation. It "allows plaintiffs to rely on the presumption that certain statements of a company, such as financial reports, prospectuses, registration statements, and press releases, are the collective work of those high-level individuals with direct involvement in the everyday business of the company." *Sutton v. Bernard,* No. 00 C 6676, 2001 WL 897593, at *5 n. 5 (N.D.Ill. Aug.9, 2001).

The group pleading doctrine, however, predates the enactment of the PSLRA. The Seventh Circuit has yet to address whether the doctrine survives the PSLRA, and the courts in this District are split. *Compare Danis v. USN Communications, Inc.*, 73 F.Supp.2d 923, 939 n. 9 (N.D. Ill.1999) (allowing plaintiffs to rely on the group pleading doctrine), with *Chu v. Sabratek Corp.*, 100 F.Supp.2d 827, 835-37 (N.D.Ill.2000) (disagreeing with *Danis* and concluding that allegations based on an individual's position within the company are insufficient under the PSLRA).

It is not entirely clear what effect the PSLRA has on the group pleading doctrine with respect to holding individual defendants liable for statements by the company.[7] Even if the group pleading doctrine survives the PSLRA in some form, however, it is apparent that the statute requires Plaintiffs to allege facts that support an inference that the statement is attributable to individual defendants. The PSLRA obligates a plaintiff to allege specific facts as to each of the defendant's misrepresentations or omissions. 15 U.S.C. § 78u-4(b)(1). A plaintiff is therefore required at least to include allegations in

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[7] It is entirely clear, however, that the PSLRA abolishes the use of the group pleading doctrine to allege defendant's scienter. *See infra*, Section III.B.

the complaint relating to an individual defendant's duties or legal obligations that create a presumption that the company's statement was somehow caused by or attributable to an individual defendant. Simply alleging an individual defendant's title is not enough. Unfortunately for Plaintiffs, that is all they have done. Plaintiffs have not adequately alleged that any individual defendant is liable for Tellabs' statements, even if some form of the group pleading doctrine is still viable. Accordingly, the Court will not consider Tellabs' alleged misrepresentations or omissions in determining whether Plaintiffs have stated a claim against the Individual Defendants.

III. Count One—Section 10(b) Violations

In order to state a claim under Section 10(b), Plaintiffs must allege that Defendants: (1) made a false statement or omission; (2) of a material fact;[8] (3) with scienter; (4) in connection with the purchase or sale of securities; (5) upon which Plaintiffs justifiably relied; and (6) the reliance proximately caused Plaintiffs' damages. *In re HealthCare Compare Corp.*, 75 F.3d at 280. Defendants contend that Plaintiffs have failed to satisfy these pleading requirements with respect to any statement by any Defendant.

A. False Statement or Omission

1. Allegations regarding Ryan and Pullen

Plaintiffs cannot sustain a cause of action against Pullen or Ryan in count one because the Complaint does not allege that any statements, much less any misrepresentations or omissions, are attributable to Ryan and nothing that is even close

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[8] A statement is material if "there is a substantial likelihood that disclosure of the information would have been viewed by the reasonable investor to have significantly altered the total mix of information." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995).

to a misrepresentation or omission by Pullen.[9] The only allegations particularized to Ryan or Pullen relate to the office that they held at Tellabs. This is not enough.

2. Allegations regarding Birck, Gruenwald, Kohler, Souders and Kosik

Similarly, the Complaint does not contain any facts particularized to the Defendants that sold stock—Birck, Gruenwald, Kohler, Souders and Kozik—to support their role in the misrepresentations or omissions. The Court is again left only with the titles of these individuals. Without more, Plaintiffs have not properly alleged that Tellabs' misrepresentations or omissions are attributable to these Defendants. The group pleading allegations that Plaintiffs use to include these Defendants in count one are insufficient to withstand the mandates of the PSLRA. Further, the Plaintiffs' repeated references to "Defendants" or "Individual Defendants" do not satisfy the PSLRA's requirements of pleading with specificity as to each Defendant. Accordingly, count one is dismissed with respect to Defendants Pullen, Ryan, Birck, Gruenwald, Kohler, Souders and Kozik.

3. Allegations regarding the Statement by Jackman

Plaintiffs only attribute one allegedly false statement to Jackman. (R. 40-1, Compl.¶ 68.) In response to a question regarding why revenues were not recognized on the TITAN 6500, Jackman responded: "There's nothing in the revenue recognition issue that should be construed to imply that the testing and the customer's acceptance of these systems are having difficulty." (R. 40-1, Compl.¶ 68.) Plaintiffs fail to detail what is false or misleading about this statement.

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[9] The only statement from the Complaint that is attributable to Pullen is included in the December 11, 2000 press release. That release quotes Pullen as saying, "Tellabs is making all-optical networking a reality." (R. 40-1, Compl.¶ 52.) There is nothing in the Complaint, however, that suggests that this statement is a misrepresentation.

Although Plaintiffs allege that the "Defendants" knew or recklessly disregarded that the production of the TITAN 6500 was far behind schedule and inferior to competitors' products, this allegation does not affect the veracity of Jackman's statement. Accordingly, Jackman's statement is not actionable under the allegations in the Complaint.

4. Allegations regarding Statements by Tellabs and Notebaert[10]

Plaintiffs base their Section 10(b) allegations against Tellabs and Notebaert primarily on two types of statements: (a) statements regarding Tellabs' fourth quarter 2000 financial results and (b) projections pertaining to Tellabs' future financial performance.

a. Fourth Quarter 2000 Financial Results

Plaintiffs allege that Defendants' statements regarding Tellabs' fourth quarter 2000 financial results were false and misleading because Tellabs had inflated its revenue figures for that quarter. Defendants argue that Plaintiffs have failed to plead sufficient facts to support their claims that Tellabs wrongfully inflated its revenues during the fourth quarter of 2000. Plaintiffs counter that they have pled the following activities which rendered Defendants' statements regarding Tellabs' fourth quarter false and misleading: (1) Defendants engaged in "channel stuffing" by (a) over-inventorying customers such as Telcobuy.com and SBC with products that the companies did not need to conceal the decline in demand for the TITAN 5500, (b) offering discounts and other incentives to customers and Value Added Resellers ("VARs") in order to increase fourth quarter 2000 sales to the detriment of first quarter 2001, and (c) entering into numerous con-

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[10] Unlike its treatment of the other Individual Defendants, the Complaint does detail many statements by Notebaert. (*See e.g. id.* ¶¶ 58, 59, 60, 68, 73, 74, 76, 81 & 88.)

signment transactions for products they knew, or recklessly disregarded, would not be needed by customers;[11] and (2) Defendants failed to take the required write down for excess and obsolete inventory which had accumulated since mid-2000. Plaintiffs argue that they have alleged particularized facts to support each of these activities that render Defendants' statements false and misleading.

(1) Channel Stuffing

"Channel stuffing" is the inducement of customers to substantially increase their purchases before they would otherwise buy products from the company in the normal course. *Greebel v. FTP Software*, 194 F.3d 185, 202 (1st Cir.2002). It results in the shifting of earnings into earlier quarters, which likely harms earnings in later quarters. *Id.* Plaintiffs allege on information and belief that Tellabs engaged in three different types of "channel stuffing."

(a) Over-Inventorying

Plaintiffs maintain that Tellabs "aggressively and improperly over-supplie[ed] customers with products by 'stuffing' its distribution channels with products that distributors and resellers could not sell. They contend that Defendants knew or recklessly disregarded that Tellabs' customers were over inventoried with the TITAN 5500 such that they would be decreasing their orders in the future, thereby causing Tellabs to experience future declines in sales." (R. 40-1, Compl. ¶ 64.) Plaintiffs contend that these "channel stuffing" activities artificially stimulated revenue in the short term for fourth quarter 2000.

Although the Complaint contains numerous conclusory allegations regarding Defendants' "channel stuffing" activi-

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[11] Although Defendants contend that all of these categories are not "channel stuffing" activities, but rather separate activities, in viewing the Complaint in the light most favorable to Plaintiffs, the Court disagrees.

ties, it includes only one "over inventorying" example to support those conclusions. Specifically, Plaintiffs allege that Tellabs engaged in "channel stuffing" in late 2000 in connection with sales to SBC Communications ("SBC") through Telcobuy.com by "over-inventorying Telcobuy.com during the fourth-quarter." (*Id.* ¶ 64.) Plaintiffs allege that Defendants over-inventoried customers such as Telcobuy.com and SBC with products that these companies did not need. (*Id.* ¶ 64.) Plaintiffs allege that "[a]s a result of the decline in demand, Telcobuy.com could not sell the products to SBC and thereafter requested to return the products to Tellabs in the beginning of 2001." (*Id.*)

Plaintiffs do not allege these facts with sufficient particularity. Specifically, the Complaint does not identify the particular terms of the "channel stuffing" with Telcobuy.com or any other customers, the individuals involved in the practice, or the documents exchanged in connection with it. Plaintiffs rely almost exclusively on general conclusions to support their proposition that Defendants knew or recklessly disregarded that Telcobuy.com could not sell Tellabs products to SBC after the over-inventorying. Plaintiffs' allegation that Telcobuy.com requested to return the products to Tellabs—rather than relying on an agreement to return them—in the beginning of 2001 undermines their allegations that an agreement was in place to engage in "channel stuffing."

Plaintiffs also allege that Tellabs' product returns were extremely heavy in January and February 2001, causing Tellabs to lease two additional storage facilities. (R. 40-1, Compl.¶ 101.) Plaintiffs allege that Bell Atlantic, Lexcom and Telcobuy.com were three customers that were returning products.[12] Plaintiffs, however, fail to support this claim with

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[12] Plaintiffs also allege that the returns were in the "millions" of dollars (R. 40-1, Compl.¶ 101.) Given that Tellabs' fourth quarter 2000 sales were more than a billion dollars, Plaintiffs' allegations of the dollar

any facts supporting that Defendants sold products in the fourth quarter of 2000 knowing that they would be returned by Bell Atlantic or Lexcom in 2001.[13] Without more, Plaintiffs have failed to allege that the statements regarding fourth quarter performance were misleading when made. Absent more, Plaintiffs are doing nothing more than playing Monday morning quarterbacks. Plaintiffs have not done enough to satisfy the *Novak* standard of sufficiency of pleading on information and belief.

(b) Incentives

Plaintiffs also allege that Tellabs' employees were instructed to offer discounts and other incentives to customers and VARs in order to increase Tellabs' sales for the fourth quarter of 2000. (*Id.* ¶¶ 64, 98.) To induce customers to purchase additional products, Plaintiffs allege that Tellabs offered "bundle opportunities" through payment discounts, offered substantial discounts in amounts of 10 to 20% and offered extensive credit terms. (*Id.*) These incentive activities, according to Plaintiffs, enabled Tellabs to improperly recognize revenue and falsely portray Tellabs' fourth quarter financials.

In the business world, there certainly is nothing inherently wrong with offering incentives to customers to purchase products. Plaintiffs allege that customers such as Sprint and SBC were convinced to "take products" because of these

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amount of the returns are not specific enough for the Court to determine whether the "channel stuffing" related to product returns meet the materiality pleading standard.

[13] The Court recognizes that "channel stuffing" may have occurred regardless of the returns, because Tellabs customers may have been buying in the fourth quarter 2000 what they otherwise would have purchased in the first quarter 2001. Plaintiffs have not, however, provided any details to support this "channel stuffing" theory relating to these transactions.

incentives. Plaintiffs fail, however, to allege any facts supporting that such incentives were improper. For example, they do not provide specific examples of such practices or explain particular terms of such incentives. Plaintiffs must particularize their facts in order to proceed.

(c) Consignment

Plaintiffs also argue that they meet the pleading requirements of the PSLRA for the allegedly false statements regarding Tellabs' fourth quarter 2000 revenues through their allegations of consignment. Plaintiffs allege that Tellabs falsely inflated its fourth quarter revenues through a serious of consignment transactions for products which Defendants knew the customers would not need. (R. 40-1, Compl.¶ 64, 98.) Plaintiffs also allege this specific example:

> For example, after Tellabs booked a consignment transaction entered into with the VAR Lexcom as a sale, it shipped TITAN 5500 equipment in the beginning of 2001. Because Tellabs did not have a commitment from SBC to purchase all of the equipment, and SBC didn't need all of the equipment, Lexcom returned approximately $20 million worth of unused unneeded products in the second quarter of 2001.

(*Id.*)

Plaintiffs argue that Defendants should not have recognized the revenue from these sales during the fourth quarter of 2000 because they were consignment sales, and that Defendants violated GAAP by doing so. Although Plaintiffs have come close to particularizing this allegation, they fail to include the terms of the consignment.

(2) Obsolete Inventory

Finally, Plaintiffs allege that the statements regarding Tellabs' fourth quarter 2000 financial results were false and misleading when made because "defendants had improperly

failed to take a required write-down for excess and obsolete inventory which had been accumulating steadily since mid-year 2000." (R. 40-1, Compl. ¶ 64.) Plaintiffs claim that this resulted in Tellabs artificially inflating the value of its assets and stockholders equity. (*Id.*)

In similar situations, the Seventh Circuit has found that these allegations do not amount to fraud. In *DiLeo*, the Seventh Circuit affirmed a dismissal of a complaint where the plaintiffs sought to recover for tardy write-offs of bad loans. 901 F.2d at 627. The Seventh Circuit found that the complaint was deficient because it did not provide "a single concrete example" of how the write-offs were fraudulent. *Id.* The court went on to state, "[i]f all that is involved is a dispute about the timing of the writeoff, based on estimates of the probability that a particular debtor will pay, *we do not have fraud*; we may not even have negligence." *Id.* (emphasis added). In *Grassi v. Information Resources, Inc.*, 63 F.3d 596 (7th Cir.1995) the Seventh Circuit extended this principle outside of the loan context, to investments overall. *Id.* at 600 ("Plaintiffs essentially claim that IRI should have written off its bad investment sooner—but this is not fraud.").

Based on these cases, a plaintiff must allege more than delinquent write-offs. Instead, a complaint must specifically state how the delinquent write-offs somehow went beyond a bad business decision or negligence, and instead actually constituted fraud. Accordingly, Plaintiffs' write-down allegations fail to support a claim for fraud. The Complaint does not state how the failure to take the write-downs was fraudulent. It does not state the amount of the write-downs, what the obsolete inventory was, or why the write-downs were required to be taken then. Accordingly, Plaintiffs' write-off allegations do not support a cause of action against Defendants. Taking Plaintiffs' allegations of "channel stuffing" and write-off failures as a whole, they have not sufficiently pled a cause of action under the PSLRA.

b. Other Statements

Many of the other statements by Tellabs and Notebaert that Plaintiffs allege are false cannot support a cause of action in count one. In some instances, Plaintiffs have not alleged what is false about the statements. In other cases, the statements are not actionable because they are merely puffery.

(1) No allegations of falsity

Plaintiffs have alleged that other statements made by Defendants were false and misleading, including statements in the following press releases: December 11, 2000, May 31, 2001 and June 5, 2001. Defendants correctly note, however, that Plaintiffs fail to allege what, if anything, was false or misleading in Tellabs' December 11, 2000 press release regarding its optical networking strategy or its May 31, 2001 press release announcing a $262 million restructuring charge. Furthermore, the Complaint does not contain facts supporting the falsity of Tellabs' June 5, 2001 announcement of the introduction of a new software system for the TITAN 6500. As such, these statements are not actionable.

(2) Puffery

"Courts consistently hold that mere puffery and glowing representations of expected boom are not enough to state claims" under the Exchange Act. *Donovan v. ABC-NACO Inc.*, No. 02 C 1951, 2002 WL 1553259, at *7 (N.D.Ill. July 15, 2002) (citations and quotations omitted); *see also Anderson v. Abbott Labs.*, 140 F.Supp.2d 894, 904 (N.D.Ill.), *aff'd sub nom. Gallagher v. Abbott Labs.*, 269 F.3d 806 (7th Cir.2001). The majority of Plaintiffs' allegations regarding the progress of the TITAN 6500 and the TITAN 6700 are merely "puffery." For example, the January 23, 2001 press release noted that "[w]ith [the TITAN 6700], scheduled for second-quarter field trials and fourth-quarter availability, Tellabs completes a bandwidth management portfolio that scales from a single call to an entire wavelength of light."

That same day, Defendant Notebaert stated: "On the 6500, demand for that product is exceeding our expectations . . . ." Notebaert also stated: "We feel very, very good about the robust growth we're experiencing." Later, on March 8, 2001, Notebaert said, "[w]e are as confident as ever—that may be an understatement—about the 6500." These statements are nothing more than puffery and cannot be the basis of a cause of action in count one.

c. Projections

Plaintiffs also allege that Defendants violated Section 10(b) of the Exchange Act through multiple projections or forward looking statements about Tellabs' financial future. The Seventh Circuit has noted that "cases involving forward-looking statements are unique." *In re HealthCare Compare Corp.*, 75 F.3d at 281. "[A]n inability to foresee the future does not constitute fraud, because '[t]he securities laws approach matters from an *ex ante* perspective.'" *Eckstein v. Balcor Film Investors*, 8 F.3d 1121, 1132 (7th Cir.1993). In order for projections to be actionable, Plaintiffs must allege that Defendants made them with "the knowledge that they are incorrect or are otherwise without reasonable basis." *Katz v. Household Int'l., Inc.*, 91 F.3d 1036, 1039 (7th Cir.1996). "Projections which turn out to be inaccurate are not fraudulent simply because subsequent events reveal that a different projection would have been more reasonable." *In re HealthCare Compare*, 75 F.3d at 281. "[A]s long as those statements had a reasonable basis when made, they do not constitute fraud." *Searls v. Glasser*, 64 F.3d 1061, 1066 (7th Cir.1995) (citing *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 513 (7th Cir.1989)).

Defendants argue that the Court must dismiss Plaintiffs' claims regarding Tellabs' revenue projections because the projections are protected by the PSLRA's safe harbor, and because Plaintiffs have failed to allege that they were unreasonable when made. Because the Court agrees that the

projections are protected by the PSLRA's safe harbor and thus not actionable, the Court need not address the allegations pertaining to the reasonableness of these projections when made.

(1) The Allegations

Plaintiffs identify a series of revenue projections made by Tellabs in its press releases, teleconferences with analysts and its 2000 10-K. Each of these projections pertains to Tellabs' financial performance for the year 2001. (*See* R. 40-1, Compl. ¶¶ 55-56, 60-61, 65, 67-69, 71, 77.)

These projections include a December 12, 2000 call with analysts where Tellabs provided revenue guidance for 2001 and estimated 30% sales growth. (R. 40-1, Compl.¶ 54-55.) They also include a press release and conference call with securities analysts on January 23, 2001 where Tellabs "reassured investors" as to the Company's 2001 projections. (*Id.* ¶ 58.) During that same day in an interview with Eric Schatzker from the Bloomberg News, Notebaert stated "We feel very, very good about the robust growth we're experiencing." (*Id.* ¶ 60.) Furthermore, Plaintiffs allege that on March 7, 2001, Tellabs updated its guidance for the first quarter reducing its projections of first quarter sales to the range of $830 to $865 million. (*Id.* ¶ 68.) Notebaert then stated, "[w]e still expect revenue and EPS growth for the quarter to exceed 30%. Tellabs will meet the adjusted revenue and earnings targets." Tellabs' 10-K, filed on March 29, 2001, contained similar statements. (*See id.* ¶¶ 71-72.)

(2) The PSLRA's Safe Harbor for Forward-Looking Statements

Congress explicitly incorporated a "safe harbor" for projections into the PSLRA. That safe harbor provides, in relevant part, that a defendant is not liable with respect to any oral or written forward-looking statement that is identified as such and is either (1) "accompanied by meaningful cautionary

statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement" or (2) immaterial.[14] 15 U.S.C. § 78u-5(c)(1)(A)(i) & (ii). Meaningful cautionary language, however, must be substantive and tailored to the specific predictions made in the allegedly misleading statement. *In re Donald J.Trump Casino Sec. Litig. Taj Mahal Litig.*, 7 F.3d 357, 371-372 (3d Cir.1993). "A vague or blanket disclaimer which merely warns the reader that the investment has risks will ordinarily be inadequate to prevent misinformation." *Id.*

(a) Forward-Looking Statements

As an initial matter, the Complaint alleges and Plaintiffs argue that the statements at issue here are not forward-looking statements, thus the safe harbor does not apply. The Court disagrees.

The statute defines the term "forward looking statement" to include "a projection of revenues, income (including income loss), earnings (including earnings loss) per share, capital expenditures, dividends, capital structure or other financial items." 15 U.S.C. § 78u-5(i)(1)(A). It also includes "a statement of future economic performance, including any such statement contained in a discussion and analysis of financial condition by the management or in the results of operations included pursuant to the rules and regulations of the Commission." 15 U.S.C. § 78u-5(i)(1)(C). The above statements clearly constitute revenue projections and statements about Tellabs' future economic performance. Accordingly, they squarely fall within the PSLRA's definition of forward-looking statements.

(b) Cautionary Language

Defendants argue that Tellabs' revenue projections are protected by the safe harbor provisions because the revenue

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[14] The safe harbor also has a scienter element that the Court discusses *infra* at Section III.B.3.

projections at issue contained cautionary language.[15] The projections, they argue, explicitly warned investors of the risks and uncertainties associated with the forward-looking statements. Defendants contend that the projections in Tellabs' press releases, teleconferences with analysts and 10-K all contain such safe harbor language.

The January 23, March 7 and April 6, 2001 press releases at issue, for example, contained the following warnings:

> Forward-Looking Statements—This news release contains forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, risks associated with introducing new products, entering new markets, availability of resources, competitive response, and a downturn in the telecommunications industry. The company undertakes no obligation to revise or update these forward-looking statements to reflect events or circumstances after today or to reflect the occurrence of unanticipated events. For a more detailed description of the risk facts, please refer to the company's SEC filings.

(R. 49-1, Defs.' Appx.) Furthermore, the company made a similar disclaimer in its calls with securities analysts.[16] At

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[15] Plaintiffs argue that the question of whether such language sufficiently "cautionary" or "meaningful" to qualify under the PSLRA's safe harbor is a question of fact that is inappropriate for this Court to decide on a motion to dismiss. This argument directly contradicts the PSLRA, which explicitly provides that "the court shall consider any statement cited in the complaint and any cautionary statement accompanying the forward-looking statement" in deciding a motion to dismiss. 15 U.S.C. § 78u-5(e).

[16] The parties have not provided the Court with the transcript of the December 12, 2000 analyst call, during which Tellabs projected 30% growth for 2001, so the Court cannot conclude that the revenue projections in that call fall within the PSLRA's safe harbor.

the inception of the March 7, 2001 teleconference with the securities analysts, John Springer specifically noted:

> "Before we begin, and in keeping with the safe harbor provision of the Securities Litigation Reform Act of 1995, I would like to state that except for historical information, the following teleconference is based on preliminary financial results which are subject to further review and adjustment and contain forward-looking statements that involve risks and uncertainties. Actual results may differ from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to risks associated with introducing new products, entering new markets, availability of resources, competitive response, and the economic conditions in the telecommunications industry."

(*Id.*) He further noted that "the Company undertakes no obligation to revise or update these forward-looking statement [sic] to reflect the occurrence of unanticipated events." (*Id.*) Tellabs' 10-K for fiscal year 2000 contained even more detailed safe harbor language. (*Id.*)

The language accompanying these forward-looking statements clearly falls within the PSLRA's safe harbor for projections. Contrary to Plaintiffs' assertions, this language is not vague or boilerplate. It specifically identifies risks that could affect the projections. Accordingly, the projections are protected by the PSLRA's safe harbor.[17]

B. Scienter

Defendants also contend that Plaintiffs have failed to plead scienter with particularity for both its alleged misrepre-

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[17] Because these projections are protected by the PSLRA's safe harbor, the Court does not need to address Defendants' argument that Plaintiffs have failed to particularize the facts supporting their allegations of false projections.

sentations and projections. Rule 9(b) does "not require 'particularity' with respect to the defendants' mental state." *DiLeo*, 901 F.2d at 629. The PSLRA, however, does impose heightened pleading requirements for scienter. Specifically, the PSLRA requires that Plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2).

Under Section 10(b), scienter is either "the intent to deceive, manipulate or defraud," *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976), or the "reckless disregard for the truth of the material asserted." *S.E.C. v. Jakubowski*, 150 F.3d 675, 681 (7th Cir.1998). "Reckless conduct is, at least, conduct which is highly unreasonable and which represents an extreme departure from standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it." *Rehm v. Eagle Fin. Corp.*, 954 F.Supp. 1246, 1255 (N.D.Ill.1997).

The Seventh Circuit has not yet addressed the heightened pleading requirements for scienter under the PSLRA. But as this Court recently noted in *Wafra Leasing Corp. v. Prime Capital Corp.*, 247 F.Supp.2d 987 (N.D.Ill. 2002), the Second Circuit articulated a standard for scienter allegations that several other courts in this District have adopted. Under this Second Circuit standard, a plaintiff is required to allege either: (1) facts showing that the defendants had both motive and opportunity to commit fraud, or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Id.* at 997; *see also Press v. Chemical Investment Servs. Corp.*, 166 F.3d 529, 538 (2d Cir.1999) (citations and quotations omitted). The Court rejects the Second Circuit standard because it is inconsistent with the plain language of the PSLRA. *See Wafra Leasing*, 247 F.Supp.2d at 997. Instead, Plaintiffs may use "motive and opportunity" or "circumstantial evidence" to establish scienter under the PSLRA,

as long as Plaintiffs' allegations support a strong inference that Defendants acted recklessly or knowingly. *Id.*

1. Group pleading and scienter

With respect to the alleged material misrepresentations or omissions, Plaintiffs must allege facts establishing that each individual defendant knew, or recklessly ignored, that the statements were materially false or misleading, thereby artificially inflating the price of Tellabs' stock. Group pleading allegations are insufficient under the PSLRA to establish scienter on the part of each individual Defendant. *See In re Digital Island Sec. Litig.*, 223 F.Supp.2d 546, 553 (D.Del.2002) ("courts have reasoned that the requirement under the PSLRA that scienter be pled with particularity as to each defendant would be rendered meaningless should group pleading survive"); *Chu*, 100 F.Supp.2d at 837 (rejecting the group pleading doctrine and concluding that "[t]o the extent the plaintiffs plead scienter based exclusively on an individual defendant's position in Sabratek's hierarchy, their claims must be dismissed."). Accordingly, Plaintiffs must meet the PSLRA's heightened scienter pleading requirement with respect to each Defendant.

The Complaint is replete with allegations that "Defendants" or the "Individual Defendants" acted with the requisite scienter. (*See, e.g.*, R. 40-1, Compl. ¶¶ 57, 64, 76, 113.) The Complaint is devoid of any specific allegations as to the scienter of Defendants Pullen, Ryan and Jackman. Accordingly, count one of the Complaint is dismissed without prejudice with respect to these individual defendants.

2. Scienter and Insider Trading

Plaintiffs argue that the stock sales during the purported Class Period by Defendants Birck, Gruenwald, Kohler, Kozik and Souders raise a strong inference of scienter. They contend that these Defendants personally profited from the artificially inflated stock price during the purported Class

Period, thus providing a motive for them to make the alleged misrepresentations that allegedly caused the inflated stock price.

Although the Seventh Circuit has not addressed the issue of whether insider trading allegations are sufficient to establish a strong inference of scienter, this Court agrees with the federal appellate courts that have found that mere allegations of insider trading during the purported Class Period alone are not enough to sufficiently allege a strong inference of scienter. *See e.g., In re Navarre Corp. Sec. Litig.*, 299 F.3d 735, 747 (8th Cir.2002) ("Insider stock sales are not inherently suspicious . . . ."); *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1037 (9th Cir.2002); *Greebel*, 194 F.3d at 198 ("mere pleading of insider trading, without regard to either context or the strength of the inference to be drawn, is not enough"). It may be possible, however, for "unusual" or "suspicious" stock sales by corporate officers to constitute circumstantial evidence of scienter. *See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. America West Holding Corp.*, 320 F.3d 920, 938 (9th Cir.2003) ("'unusual' or 'suspicious' stock sales by corporate insiders may constitute circumstantial evidence of scienter"); *In re Rockefeller Center Properties, Inc. Sec. Litig.*, 311 F.3d 198, 225 (3d Cir.2002) ("if the stock sales were unusual in scope or timing, they may support an inference of scienter."); *In re K-tel Intern., Inc. Sec. Litig.*, 300 F.3d 881, 907 (8th Cir.2002) (same); *In re Nike, Inc. Sec. Litig.*, 181 F.Supp.2d 1160, 1169 (D.Or.2002). In order to rise to the level of "unusual" or "suspicious," the insider trading must be "dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information." *In re Silicon Graphics, Inc.*, 183 F.3d at 986 (internal quotation omitted). In determining whether the insider trading allegations rise to this level, the Court can consider the amount and percentage of overall shares sold, the profit made, the timing of the stock sales and the consistency

of the sales with the insider's prior trading history. *See id.; Florida State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 659 (8th Cir.2001) ("the insider trades have to be unusual, either in the amount of profit made, the amount of stock traded, the portion of stockholdings sold, or the number of insiders involved"); *Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir.2000).

The Complaint only sets forth the number of shares of common stock that Birck, Gruenwald, Kohler, Kozik and Souders sold and the amount of trading proceeds each person received for his or her sales. Plaintiffs argue that the timing of these sales between January 31, 2001 and February 15, 2001 supports a strong inference of scienter. The Complaint, however, fails to allege the prior history of stock sales for these Defendants, the number of shares held by each Defendant or the percentage of shares each Defendant sold of his or her stock. These bare-bones stock sale allegations do not amount to anything unusual or suspicious. They clearly are insufficient by themselves to create a strong inference of scienter. *See Greebel*, 194 F.3d at 196-97; *In re E Spire*, 127 F.Supp.2d 734, 743 (D.Md.2001). This is especially true here because Plaintiffs never allege that Birck, Gruenwald, Kohler, Kozik or Souders made any misrepresentations. *See In re Visual Networks, Inc. Sec. Litig.*, 217 F.Supp.2d 662, 668-69 (D.Md.2002); *E Spire*, 127 F.Supp.2d at 743.

Plaintiffs have attached "stock sale charts" to their memorandum opposing Defendants' motion to dismiss that allegedly demonstrate the trading activity of Birck, Gruenwald, Kohler, Kozik and Souders during an eighteen month period. Not only do Plaintiffs fail to include these allegations in their Complaint, but the charts do not support their contentions. Specifically, the charts reflect that Gruenwald and Birck had stock sales prior to those in the purported Class Period. Furthermore, the charts do not contain any information regarding the total stock holdings of each of these Defendants.

Furthermore, Plaintiffs have alleged that ten Individual Defendants were part of a scheme to defraud in this case. They also allege, however, that only five of these Defendants sold stock during the purported Class Period. Given that only half of the named Defendants sold stock during the purported Class Period, Plaintiffs' motive allegations are weakened. *See San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos., Inc.*, 75 F.3d 801, 814 (2d Cir.1996) (strong inference of company's scienter not established by significant sale of stock by one company executive); *Rehm*, 954 F.Supp. at 1251 (finding no strong inference of scienter where two of three individuals defendants did not sell stock during class period). The Court concludes that the sale of stock alone by Birck, Gruenwald, Kohler, Kozik and Souders does not give rise to a strong inference of scienter as mandated under the PSLRA.

3. Scienter and Accounting Standards

Plaintiffs further argue that they have satisfied the scienter pleading requirements through their allegations of accounting violations. Standing alone, allegations that a defendant violated GAAP and American Institute Of Certified Public Accountants ("AICPA") accounting standards are generally insufficient to create a strong inference of scienter. *See, e.g., Navarre*, 299 F.3d at 745; *Geinko v. Padda*, No. 00 C 5070, 2001 WL 1163728, at *4 (N.D.Ill. Sept.28, 2001). Instead, to allege a strong inference of scienter, the "complaint must also show facts supporting an inference that defendants recklessly disregarded the deviance or acted with gross indifference to the misrepresentations in its financial statements." *In re System Software Assocs., Inc.*, No. 97 C 177, 2000 WL 283099, at *14 (N.D.Ill. Mar.8, 2000).

Plaintiffs allege that Defendants violated GAAP by employing improper accounting practices, which falsely inflated Tellabs' balance sheet. Plaintiffs claim that Defendants caused Tellabs to violate GAAP by improperly accelerating

revenues through "channel stuffing." The Court addressed the insufficiency of the "channel stuffing" allegations in Section III. Specific to scienter, Plaintiffs have not alleged sufficient facts to show that Defendants knew or recklessly disregarded at the time of making the transactions that customers would be returning products in the first quarter of 2001.

Similarly, Plaintiffs allege that Defendants violated GAAP by neglecting to write-off obsolete inventory until the second quarter of 2001. The Court also addressed the deficiencies in the pleading of this scheme in Section III. As with "channel stuffing" scienter, Plaintiffs have not alleged sufficient facts to show that Plaintiffs had scienter when failing to write-off the obsolete inventory during the fourth quarter of 2001.

4. Other Scienter Allegations

Plaintiffs also contend that the Individual Defendants knew facts or recklessly disregarded information at their disposal that contradicted their public statements. As noted above, however, they do not individualize their allegations as to each of these Defendants, as they must. Conclusory allegations of reckless disregard are insufficient to raise a strong inference of scienter. *See In re Azurix Corp. Sec. Litig.*, 198 F.Supp.2d 862, 891 (S.D.Tex.2002).

In addition, Plaintiffs rely on the Defendants' positions within Tellabs in support of their scienter argument. "A pleading of scienter may not rest on the inference that defendants must have been aware of the misstatement based on their positions within the company." *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 432 (5th Cir.2002). Accordingly, this argument fails as well.

With respect to Tellabs itself, Plaintiffs have not alleged how an individual's knowledge can be imputed to the corporation to find that it had the requisite scienter. This is an important allegation because only the knowledge obtained

by corporate employees acting within the scope of their employment can be imputed to the corporation. *United States v. One Parcel of Land*, 965 F.2d 311, 315 (7th Cir.1992). Although the majority of the allegedly misleading statements were made in company documents, such as press releases and the Company's 10-Ks, Plaintiffs have not alleged with any particularity which officers, directors, or employees acting within their scope of duties had knowledge that the statements were misleading.. [sic]

5. Projections

The PSLRA imposes an even higher pleading burden for projections or forward-looking statements. The PSLRA specifically states that a defendant will be liable for a forward-looking statement only where it "was made with actual knowledge . . . that the statement was false or misleading." 15 U.S.C. § 78u-5(c)(1)(B)(i). *See also Theoharous v. Fong*, 256 F.3d 1219, 1225 (11th Cir.2001) (with respect to forward-looking statements, "the plaintiff must prove that the defendant made the statement with 'actual knowledge' that it was 'false or misleading.'"); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 549 & n. 5 (6th Cir.1999) (noting that the PSLRA requires plaintiffs to allege facts that raise a strong inference that the defendants had actual knowledge of a forwardlooking statement's falsity). Thus, under the plain language of the statute mere allegations of recklessness are insufficient to establish liability for projections. For the reasons discussed above, Plaintiffs' allegations fail to raise a strong inference of actual knowledge on the part of any of the Defendants.

V. Count Two—Section 20(a) Liability

Count two seeks liability against the Individual Defendants for violating Section 20(a) of the Exchange Act. Section 20(a) provides: "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or

of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a).

Plaintiffs must allege the following in order to state a Section 20(a) claim: (1) a primary securities violation; (2) each of the Individual Defendants exercised general control over the operations of Tellabs; and (3) each of the Individual Defendants "possessed the power or ability to control the specific transaction or activity upon which the primary violation was predicated, whether or not that power was exercised." *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir.1992). Because Plaintiffs' Section 20(a) claim is one of fraud, Plaintiffs must meet the heightened pleading requirements of Federal Rule of Civil Procedure 9(b). Plaintiffs, however, need not meet the heightened pleading requirements of the PSLRA to establish control person liability.

Defendants argue that the Court should dismiss count two for failure to state a claim for control person liability under Section 20(a) on the following grounds: (1) Plaintiffs fail to allege a predicate securities fraud violation; and (2) Plaintiffs fail to allege that Defendants Gruenwald, Kohler, Puller or Souders exercised sufficient control over Tellabs to be held liable as control persons. As discussed above, the Court agrees that Plaintiffs have failed to allege a predicate Section 10(b) violation on the part of the Individual Defendants. Consequently, count two is dismissed without prejudice as to the Individual Defendants.

Moreover, the Court agrees that the Complaint does not provide sufficient allegations to conclude that Defendants Gruenwald, Kohler, Puller or Souders possessed the power or

ability to control the alleged misrepresentations and projections. The Complaint does not allege any facts to demonstrate that these Defendants were control persons or served in high-level officer positions. Gruenwald was the senior vice president and general manager of the broadband access group, Kohler was the senior vice president of global business operations, Pullen was the senior vice president and general manager of optical networking and Souders was an outsider director of Tellabs. Although Plaintiffs generally allege that these Individual Defendants "had direct and supervisory involvement in the day-to-day operations of the Company and, therefore, are presumed to have had the power to control or influence the particular transactions giving rise to the securities violations," this general allegation as to all the Individual Defendants is insufficient to establish control person liability. *See Donovan*, 2002 WL 1553259 at *6 (N.D.Ill. July 15, 2002) ("The mere fact that Plaintiff alleges these Defendants are directors is not enough" for control person liability). Accordingly, count two is dismissed without prejudice as to Defendants Gruenwald, Kohler, Puller or Souders.

VI. Count Three—Insider Trading Claim

Plaintiffs have sued Defendants Birck, Kozik, Kohler, Souders and Gruenwald in count three for insider trading pursuant to Section 20A of the Exchange Act. Section 20A expressly provides for a private cause of action against persons who purchase or sell a security "while in possession of material, nonpublic information." Such an action may be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class." *United States v. O'Hagan*, 521 U.S. 642, 666, 117 S.Ct. 2199, 2214, 138 L.Ed.2d 724 (1997) (quoting 15 U.S.C. § 78t-1(a)); *see also Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332, 1337 (7th Cir.1997). Because Plain-

tiffs have failed to allege that Defendants Birck, Kozik, Kohler, Souders and Gruenwald were in possession of material, nonpublic information when they sold their stock, count three of the Complaint is dismissed without prejudice.

## CONCLUSION

Defendants' motion to dismiss is granted. Plaintiffs have until June 27, 2003 to file a Second Consolidated Amended Complaint.

**APPENDIX D**

UNPUBLISHED ORDER
Not to be cited per Circuit Rule 53

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

July 10, 2006

Before

Hon. KENNETH F. RIPPLE, *Circuit Judge*

Hon. DIANE P. WOOD, *Circuit Judge*

Hon. DIANE S. SYKES, *Circuit Judge*

No. 04-1687

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
*Plaintiffs-Appellants*,

*v.*

TELLABS, INC., *et al.*,
*Defendants-Appellees*.

No. 02 C 04356
Amy J. St. Eve, *Judge*.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

ORDER ON PETITION FOR REHEARING

Defendants-Appellees filed a petition for rehearing *en banc* on February 8, 2006. No judge in active service has requested a vote on the petition for rehearing *en banc*.

All members of the original panel have voted to DENY rehearing except to the extent that the opinion is MODIFIED as follows: the first full paragraph on page 28 of the slip of the opinion is deleted and replaced with the following:

> The plaintiffs also pleaded a claim against Birck for insider trading. A private cause of action exists under § 20A of the Securities Exchange Act against persons who purchase or sell a security "while in possession of material, nonpublic information." See 15 U.S.C. § 78t-1(a). To create potential liability under § 20A, the plaintiffs must prove an independent violation of "this chapter or the rules or regulations thereunder." *Id.* In other words, § 20A claims are "derivative, requiring proof of a separate underlying violation of the Exchange Act." *Advanta Corp.*, 180 F.3d at 541. At this point in the litigation, we have affirmed the dismissal of the underlying securities fraud claims pleaded directly against Birck. He still faces liability, but solely as a control person under § 20(a). Whether § 20(a) control-person liability standing alone can serve as the "separate underlying violation" required for § 20A insider trading is an open question of law and raises an important issue of statutory interpretation that should not be decided in a vacuum. No party in this litigation has provided more than cursory briefing of this issue, and therefore we take no position on its resolution, leaving it for further factual and legal development during the course of the litigation.